Integrated Professional
Competence Course - Group II

Celebrating the
60th Year of Excellence

Advanced Accounting

Board of Studies
The Institute of Chartered Accountants of India
(Set up by an Act of Parliament)

PAPER 5

ADVANCED ACCOUNTING

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

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PREFACE

The paper of Advanced Accounting in the Integrated Professional Competence Course (Group II) concentrates on conceptual understanding of the crucial aspects of accounting and reporting of financial statements. Students are expected to acquire working knowledge in this paper. The importance of this subject is growing over the years due to various factors like liberalization, cross-border flow of capital, emergence of global corporations and movement towards better corporate governance practices. New Accounting Standards have been formulated keeping in mind this growing importance of Accounting in the corporate scenario. Accordingly, developing better understanding of the relevant accounting standards should be given proper emphasis while preparing for the examination.

The book is divided into nine chapters, each addressing to a special aspect of accounting. Chapter 1 deals with Conceptual Framework for Preparation and Presentation of Financial Statements and Chapter 2 propagates the working knowledge of those accounting standards which are the part of course. Chapter 3 discusses accounting of partnership firms in which advanced issues of partnership accounts are covered. Chapter 4 on company accounts is divided into five units wherein accounting for ESOPs, buy back of securities, equity shares with differential rights, underwriting of shares and debentures, redemption of debentures and advanced problems of business acquisition, amalgamation and reconstruction of companies have been discussed. Chapters 5, 6 and 7 lay emphasis on financial reporting of insurance, banking and electricity companies. Chapters 8 and 9 are devoted to accounting for special transactions i.e. departmental and branch accounts.

Learning objectives have been incorporated at the beginning of each chapter/unit to guide the students about the knowledge they should acquire after studying the chapters. Care has been taken to present the chapters in a logical sequence to facilitate easy understanding by the students. Small illustrations have been incorporated in each chapter/unit to explain the concepts/principles dealt with in the chapter/unit. Another helpful feature is the addition of self-examination questions which will help the students in preparing for the Integrated Professional Competence Examination.

SYLLABUS

GROUP II
PAPER 5: ADVANCED ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge: Working Knowledge

Objectives :

(a) To have an understanding of the conceptual framework for the preparation and presentation of financial statements,

(b) To gain working knowledge of the professional standards and application of accounting principles to different practical situations, and

(c) To gain the ability to solve advanced problems in the case of different entities.

Contents :

1. Conceptual Framework for Preparation and Presentation of Financial Statements

2. Accounting Standards

Working knowledge of:

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 11 : The Effects of Changes in Foreign Exchange Rates (Revised 2003)

AS 12 : Accounting for Government Grants

AS 16 : Borrowing Costs

AS 19 : Leases

AS 20 : Earnings Per Share

AS 26 : Intangible Assets

AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

3. Advanced Issues in Partnership Accounts

Dissolution of partnership firms including piecemeal distribution of assets; Amalgamation of partnership firms; Conversion into a company and Sale to a company.

4. Company Accounts

(a) Accounting for employee stock option plan, Buy back of securities, Equity shares with differential rights, Underwriting of shares and debentures, Redemption of debentures

(b) Advanced problems for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation of inter-company holding)

(c) Accounting involved in liquidation of companies, Statement of Affairs (including deficiency/surplus accounts) and liquidator's statement of account of the winding up.

(d) Financial Reporting of Insurance, Banking and Electricity Companies and legal and regulatory requirements thereof

5. Accounting for Special Transactions

Departmental and branch accounts including foreign branches

Note – If either old Accounting Standards (ASs), Announcements and Limited Revisions to ASs are withdrawn or new ASs, Announcements and Limited Revisions to ASs are issued by the Institute of Chartered Accountants of India in place of existing ASs, Announcements and Limited Revisions to ASs, the syllabus will accordingly include/exclude such new developments in place of the existing ones with effect from the date to be notified by the Institute.

CONTENTS

CHAPTER 1

CONCEPTUAL FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

Learning Objectives

After studying this unit, you will be able to:

- ♦ Understand the meaning of Conceptual Framework for the Preparation and Presentation of Financial Statements.
- ♦ Significance of the Conceptual Framework for the Preparation and Presentation of Financial Statements.

1.1 INTRODUCTION

The development of accounting standards or any other accounting guidelines need a foundation of underlying principles. In July 1989, The International Accounting Standards Committee (IASC) issued a Conceptual Framework to serve as a basis for the accounting standards. The Accounting Standards Board of the ICAI has issued a similar framework for the same purpose in July 2000. This framework provides the fundamental basis for development of new standards as also for review of existing standards. The principal areas covered by the framework are as follows:

(a) Components of financial statements

(b) Objectives of financial statements

(c) Assumptions underlying financial statements

(d) Qualitative characteristics of financial statements

(e) Elements of financial statements

(f) Criteria for recognition of an element in financial statements

(g) Principles of measurement of financial elements

(h) Concepts of Capital and Capital Maintenance

1.2 PURPOSE OF THE FRAMEWORK

The framework sets out the concepts underlying the preparation and presentation of general-purpose financial statements prepared by enterprises for external users. The main purpose of the framework is:

(a) To assist enterprises in preparation of their financial statements in compliance with the accounting standards and in dealing with the topics not yet covered by any accounting standard.

Example

Shares or other securities held as stock-in-trade by dealers of shares or securities are neither inventory nor investments. At present there is no accounting standard to cover valuation of shares or other securities held as stock-in-trade. However paragraph 37 of the conceptual framework requires exercise of prudence in preparation of financial statements. It is therefore advisable to value shares or other securities held as stock-in-trade as lower of cost and fair value, such the losses are anticipated but gains are not.

(b) To assist ASB in its task of development and review of accounting standards.

(c) To assist ASB in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by accounting standards.

Example

Exchange losses arising on increase in foreign currency liability incurred for acquisition of fixed assets can (i) either be capitalised (ii) or be recognised as expense in the statement of profit and loss in the accounting period in which the loss is incurred. The accounting standards (ASs) permit the second alternative only. The reason appears to be that the paragraph 93 of the framework states that 'expenses are recognised in the statement of profit and loss when a decrease in future economic benefit related to decrease in an asset or an increase in liability has arisen that can be measured reliably'. Also, as per paragraph 96 of the framework, an expense is recognised immediately in the statement of profit and loss when it produces no future economic benefits. The exchange losses increases the rupee payment required to settle the foreign currency liability but definitely does not increase the service potential of the asset. In view of this, the relevant accounting standard requires such exchange losses to be recognised as expense immediately.

It may be noted that Schedule VI of Companies Act requires capitalisation of exchange losses arising on increase in foreign currency liability incurred for acquisition of fixed assets. The Institute has taken up the matter with the government, and amendment of Schedule VI is expected.

(d) To assist auditors in forming an opinion as to whether financial statements conform to the accounting standards.

(e) To assist the users in interpretation of financial statements.

Example

As per the framework, three assumptions underlying a financial statement are (a) Going Concern (2) Accrual basis of accounting (c) Consistency. Unless contrary is disclosed, a user may assume (i) the enterprise has no plan of liquidation or significant curtailment of its activities (ii) the expenses and income recognised coincide with the concerned event, rather than with the time of cash payments or receipts and (iii) the enterprise did not change its accounting policies from those followed in previous accounting periods.

1.3 STATUS AND SCOPE OF THE FRAMEWORK

The framework applies to general-purpose financial statements usually prepared annually for external users, by all commercial, industrial and business enterprises, whether in public or private sector. The special purpose financial reports, for example prospectuses and computations prepared for tax purposes are outside the scope of the framework. Nevertheless, the framework may be applied in preparation of such reports, to the extent not inconsistent with their requirements.

Nothing in the framework overrides any specific Accounting Standard. In case of conflict between an accounting standard and the framework, the requirements of the Accounting Standard will prevail over those of the framework.

1.4 COMPONENTS OF FINANCIAL STATEMENTS

A complete set of financial statements normally consists of a Balance Sheet, a Profit & Loss A/c and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements. The component parts of financial statements are interrelated because they reflect different aspects of same transactions or other events. Although each statement provides information that is different from each other, none in isolation is likely to serve any single purpose nor can any one provide all information needed by a user.

The major information contents of different components of financial statements are as below:

- Balance Sheet portrays value of economic resources controlled by an enterprise and the way they are financed.
- Profit & Loss A/c presents the result of operations of an enterprise for an accounting period.

- Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period.
- Notes and Schedules present supplementary information explaining different items of financial statements. They may include disclosures about the risks and uncertainties affecting the enterprise and such items as disclosure of accounting policies, segmental reports, report on operations in the process of discontinuation and do on.

1.5 OBJECTIVES OF FINANCIAL STATEMENTS

The framework identifies seven broad groups of users of financial statements, namely, (a) Investors, (b) Employees, (c) Lenders, (d) Suppliers and other trade creditors, (e) Customers (f) Governments and their agencies (g) public.

Users of financial statements expect the statements to provide useful information needed to make economic decisions. The financial statements provide information to suit the common needs of most users. However, they cannot and do not intend to provide all information that may be needed, e.g. they do not provide non-financial data even if they may be relevant for making decisions. The financial statements also show the results of stewardship or accountability of the management in respect of resources entrusted to it.

1.6 FUNDAMENTAL ACCOUNTING ASSUMPTIONS

These are assumptions, the users of financial statements take for granted. As long as financial statements are prepared in accordance with these assumptions, no separate disclosure in financial statements would be necessary. There are three fundamental accounting assumptions:

(i) Going Concern

(ii) Consistency

(iii) Accrual

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been followed in their preparation of financial statements. However, if any of the above mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Let us discuss these assumptions in detail.

Going Concern

The financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations. Going concern assumption is not likely to be compatible with the intention or necessity to enter into a scheme of arrangement with the enterprise's creditors or to liquidate in near future.

Financial statements prepared on going concern basis recognise among other things the need for sufficient retention of profit to replace assets consumed in operation and for making adequate provision for settlement of its liabilities. If any financial statement is prepared on a different basis, e.g. when assets of an enterprise are stated at net realisable values in its financial statements, the basis used should be disclosed.

Example

Balance sheet of a trader on 31/03/07 is given below:

Liabilities	*Rs.*	*Assets*	*Rs.*
Capital	60,000	Fixed Assets	65,000
Profit & Loss A/c	25,000	Stock	30,000
10% Loan	35,000	Trade debtors	20,000
Trade creditors	10,000	Deferred costs	10,000
		Bank	5,000
	1,30,000		1,30,000

Additional information

(a) The remaining life of the fixed assets is 5 years. The use pattern of the asset is even. The net realisable value of fixed assets on 31/03/08 was Rs. 60,000.

(b) The trader's purchases and sales in 2007-08 amounted to Rs. 4 lakh and Rs. 4.5 lakh respectively.

(c) The cost and net realisable value of stock at the end of 31/03/05 were Rs. 32,000 and Rs. 40,000 respectively.

(d) Expenses for the year amounted to Rs. 14,900.

(e) Deferred cost is amortised equally over 4 years

(f) Closing debtors is Rs. 25,000, of which Rs. 2,000 is doubtful. Collection of another Rs. 4,000 depends on successful re-installation of certain product supplied to the customer.

(g) Closing trade creditors is Rs. 12,000, which is likely to be settled at 5% discount.

(h) Balance of closing cash is Rs. 37,100.

(i) There is an early repayment penalty for the loan Rs. 2,500.

The Profit and Loss Accounts and Balance Sheets of the trader are shown below in two cases (i) assuming going concern (ii) not assuming going concern.

Profit & Loss A/c for the year ended 31/03/08

	Case (i)	*Case (ii)*		*Case (i)*	*Case (ii)*
	Rs.	*Rs.*		*Rs.*	*Rs.*
To Opening Stock	30,000	30,000	By Sales	4,50,000	4,50,000
To Purchases	4,00,000	4,00,000	By Closing Stock	32,000	40,000
To Expenses	14,900	14,900	By Creditors	–	600
To Depreciation	13,000	5,000			
To Provision for doubtful debt	2,000	6,000			
To Deferred cost	2,500	10,000			
To Loan	–	2,500			
To Net Profit	19,600	22,200			
	4,82,000	4,90,600		4,82,000	4,90,600

Balance Sheet as at 31/03/08

Liabilities	*Case (i)* *Rs.*	*Case (ii)* *Rs.*	*Assets*	*Case (i)* *Rs.*	*Case (ii)* *Rs.*
Capital	60,000	60,000	Fixed Assets	52,000	60,000
Profit & Loss A/c	44,600	47,200	Stock	32,000	40,000
10% Loan	35,000	37,500	Trade debtors (Less provision)	23,000	19,000
Trade creditors	12,000	11,400	Deferred costs	7,500	Nil
			Bank	37,100	37,100
	1,51,600	1,56,100		1,51,600	1,56,100

Consistency

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required (i) by a statute (ii) by an accounting standard (iii) for more appropriate presentation of financial statements.

Accrual basis of accounting

Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it. While accrual basis is a more logical approach to profit determination than the cash basis of accounting, it exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain. Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting as illustrated below. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Example

(a) A trader purchased article A on credit in period 1 for Rs. 50,000

(b) He also purchased article B in period 1 for Rs. 2,000 cash

(c) The trader sold article A in period 1 for Rs. 60,000 in cash

(d) He also sold article B in period 1 for Rs. 2,500 on credit

Profit & Loss A/c of the trader by two basis of accounting are shown below. A look at the cash basis Profit & Loss A/c will convince any reader of the irrationality of cash basis of accounting.

Cash basis of accounting

Recognised cash purchase of article B and cash sale of article A in period 1

Recognised purchase of article A on payment and sale of article B on receipt in period 2

Profit & Loss A/c

		Rs.			*Rs.*
Period 1	To Purchase	2,000	Period 1	By Sale	60,000
	To Net Profit	58,000			
		60,000			60,000
Period 2	To Purchase	50,000	Period 2	By Sale	2,500
				By Net Loss	47,500
		50,000			50,000

Accrual basis of accounting:

Recognised credit purchase of article A and cash purchase of article B in period 1

Recognised cash sale of article A and credit sale of article B in period 1

Profit & Loss A/c

		Rs.			*Rs.*
Period 1	To Purchase	52,000	Period 1	By Sale	62,500
	To Net Profit	10,500			
		62,500			62,500

1.7 QUALITATIVE CHARACTERISTICS

The qualitative characteristics are attributes that improve the usefulness of information provided in financial statements. The framework suggests that the financial statements should observe and maintain the following four qualitative characteristics as far as possible within limits of reasonable cost/ benefit.

1. *Understandability* : The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities. It is not right to think that more one discloses better it is. A mass of irrelevant information creates confusion and can be even more harmful than non-disclosure. No relevant information can be however withheld on the grounds of complexity.

2. *Relevance*: The financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is said to be relevant. Such information may help the users to evaluate past, present or future events or may help in confirming or correcting past evaluations. The relevance of a piece of information should be judged by its materiality. A piece of information is said to be material if its omission or misstatement can influence economic decisions of a user.

3. *Reliability* : To be useful, the information must be reliable; that is to say, they must be free from material error and bias. The information provided are not likely to be reliable unless:

(a) Transactions and events reported are faithfully represented.

(b) Transactions and events are reported in terms of their substance and economic reality not merely on the basis of their legal form. This principle is called the principle of 'substance over form'.

(c) The reporting of transactions and events are neutral, i.e. free from bias.

(d) Prudence is exercised in reporting uncertain outcome of transactions or events.

4. *Comparability* :Comparison of financial statements is one of the most frequently used and most effective tools of financial analysis. The financial statements should permit both inter-firm and intra-firm comparison. One essential requirement of comparability is disclosure of financial effect of change in accounting policies.

5. *True and Fair View* :Financial statements are required to show a true and fair view of the performance, financial position and cash flows of an enterprise. The conceptual framework does not deal directly with this concept of true and fair view, yet the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements portraying true and fair view of information about an enterprise.

1.8 ELEMENTS OF FINANCIAL STATEMENTS

The framework classifies items of financial statements in five broad groups depending on their economic characteristics. These five financial elements are assets, liabilities, equity, Income/gains and expenses/ losses. Paragraph 49 of the framework defines assets, liabilities and equity. Paragraph 69 of the framework defines income and expenses. Gains and losses differ from income and expenses in the sense that they do not arise in the ordinary course of business. Except for the way they arise, economic characteristics of gains are same as income and those of losses are same as expenses. For these reasons, gains and losses are not recognised as separate elements of financial statements.

An item of financial element, (asset, liability, equity, expense or income) is recognised in financial statements if *both* the following criteria are met:

(a) It is probable that any future economic benefit associated with the item will flow to or from the enterprise. Concept of probability is used to ascertain the degree of uncertainty associated with the flow of economic benefits, and

(b) It has a cost or value that can be measured reliably.

In assessing whether an item of financial element meets the recognition criteria regard should be given to the materiality consideration. An item is material if misstatement or omission of the item can influence economic decision of the user. For example, an expense even if small, should be recognised if it is not tax-deductible, because one of the users of the financial statements is the taxation authority.

The recognition criteria of financial elements are inter-related. For example recognition of an asset implies that corresponding liability, income or equity should also be recognised. In other words, recognition is possible only when both of the related financial elements satisfy the specified recognition criteria. For example, in case of credit sale, the income (i.e. Sales) and asset (i.e. Debtors) can be recognised if on the basis of evidence available on balance sheet date, it is probable that the customer shall not return the goods and cash shall actually be realised.

The failure to recognise an item of financial element that meets the above criteria, is not rectified by disclosure of accounting policies used nor by notes or explanatory material.

1.8.1 Assets : An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The readers may note the following points.

(a) The resource regarded as asset, need not have a physical substance. The resource may represent a right generating future economic benefit, e.g. patents, copyrights, debtors and bills receivable. An asset without physical substance can be either intangible asset, e.g. patents and copyrights or monetary assets, e.g. debtors and bills receivable. The monetary assets are money held assets to be received fixed or determinable amounts of money.

(b) An asset is a resource controlled by the enterprise. This means it is possible to recognise a resource not owned but controlled by the enterprise as an asset. Such is the case of financial lease, where lessee recognises the asset taken on lease, even if ownership lies with the lessor. Likewise, the lessor do not recognise the asset given on finance lease as asset in his books, because despite of ownership, he does not control the asset.

(c) A resource cannot be recognised as an asset if the control is not sufficient. For this reason specific management or technical talent of an employee cannot be recognised because of insufficient control. When the control over a resource is protected by a legal right, e.g. copyright, the resource can be recognised as an asset.

(d) To be considered as asset, it must be probable that the resource generates future economic benefit. If the economic benefit from a resource is expected to expire within the current accounting period, it is not an asset. For example, economic benefit, i.e. profit on sale, from machinery purchased by a machinery dealer is expected to expire within the current accounting period. Such purchases of machinery is therefore booked as expense (Purchase A/c) rather than Machinery A/c. However, if the articles purchased by a dealer remains unsold at the end of accounting period, the unsold items are recognised as asset, i.e. closing stock, because the sale of the article and resultant economic benefit, i.e. profit is expected to be earned in the next accounting period.

(e) To considered as asset, the resource must have a cost or value that can be measured reliably.

(f) When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as expense rather than as asset.

1.8.2 Liabilities : A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits. The following points may be noted:

(a) A liability is a present obligation, i.e. an obligation the existence of which, based on the evidence available on the balance sheet date is considered more probable than not. For example, an enterprise may have to pay compensation if it loses a damage suit filed against it. The damage suit is pending on the balance sheet date. The enterprise should recognise a liability for damages payable by a charge against profit if possibility of losing the suit is reasonably certain and if the amount of damages payable can be ascertained with reasonable accuracy. The enterprise should create a provision for damages payable by charge against profit, if possibility of losing the suit is more than not losing it and if the amount of damages payable cannot be ascertained with reasonable accuracy. In other cases, the company reports the damages payable as 'contingent liability', which does not meet the definition of liability. AS 29 defines, that a provision is a liability, which can be measured only by using a substantial degree of estimation. A provision created under AS 29 is therefore a type of liability.

(b) It may be noted that certain provisions, e.g. provisions for doubtful debts, provisions for depreciation and provisions for impairment losses, represent diminution in value of assets rather than obligations. These provisions are outside the scope of AS 29 and hence should not be considered as liability.

(c) A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. Obligations under contracts equally unperformed (for example obligations against inventory ordered but not received) are not usually recognised as liabilities. If in some circumstances such an obligation is recognised as liability, the related asset / expense should also be recognised.

Example

A company has entered into a binding agreement with P Ltd. to buy a custom-made for Rs. 40,000. At the end of 2004-05, before delivery of the machine, the company had to change its method of production. The new method will not require the machine ordered and shall be scrapped after delivery. The expected scrap value is nil.

A liability is recognised when outflow of economic resources in settlement of a present obligation can be anticipated and the value of outflow can be reliably measured. The company should recognise a liability of Rs. 40,000 to P Ltd.

When flow of economic benefit to the enterprise beyond the current accounting period is considered improbable, the expenditure incurred is recognised as expense rather than as asset. In the present case, flow of future economic benefit from the machine to the enterprise is improbable. The entire amount of purchase price of the machine should be recognised as expense. The accounting entry is suggested below:

	Rs.	*Rs.*
Loss due to Change in Production Method	40,000	
To P Ltd.		40,000

1.8.3 Equity : Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, equity represents owners' claim consisting of items like capitals and reserves, which are clearly distinct from liabilities, which are claims of parties other than owners.

The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred. The definition of income and expense makes use of this fact.

1.8.4 Income: Income is increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases of liabilities that result in increases in equity other than those relating to contributions from equity participants. The definition of income encompasses revenue and gains. Revenue is an income that arises in the ordinary course of activities of the enterprise, e.g. sales by a trader. Gains are income, which may or may not arise in the ordinary course of activity of the enterprise, e.g. profit on disposal of fixed assets. Gains are shown as a separate line item in the statement of income because knowledge of them is useful in assessing performance of the enterprise.

Income earned is always associated with either increase of asset or reduction of liability. This means, no income can be recognised unless the corresponding increase of asset or decrease of liability can be recognised by application of the recognition criteria stated above.

Example

Balance sheet of an enterprise can be written in form of: A – L = E. Where:

A = Aggregate value of asset

B = Aggregate value of liabilities

C = Aggregate value of equity

Suppose at the beginning of an accounting period, aggregate values of assets, liabilities and equity of a trader are Rs. 5 lakh, Rs. 2 lakh and Rs. 3 lakh respectively.

Also suppose that the trader had the following transactions during the accounting period.

(a) Introduced capital Rs. 20,000

(b) Earned income from investment Rs. 8,000

(c) A liability of Rs. 31,000 was finally settled on payment of Rs. 30,000.

Balance sheets of the trader after each transaction are shown below:

Transactions	*Assets* Rs. lakh	–	*Liabilities* Rs. lakh	=	*Equity* Rs. lakh
Opening	5.00	–	2.00	=	3.00
(a) Capital introduced	5.20	–	2.00	=	3.20
(b) Income from investments	5.28	–	2.00	=	3.28
(c) Settlement of liability	4.98	–	1.69	=	3.29

The example given above explains the definition of income. The equity increased by Rs. 29,000 during the accounting period, due to (i) Capital introduction Rs. 20,000 and (ii) Income earned Rs. 9,000 (Income from investment + Discount earned). Incomes are therefore increases in equity without introduction of capital. Also note that income earned is accompanied by either increase of asset (Cash received as investment income) or by decrease of liability (Discount earned).

Example

A bank does not recognise interest earned on non-performing assets because the corresponding asset (increase in advances) cannot be recognised, as flow of economic benefit to the bank beyond current accounting period is not probable.

1.8.5 Expense : Paragraph 69(b) of the conceptual framework defines expense as decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants. The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid, the losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of fixed assets. Losses are shown as a separate line item in the statement of income because knowledge of them is useful in assessing performance of the enterprise.

Expenses are always incurred simultaneously with either reduction of asset or increase of liability. Thus, expenses are recognised when the corresponding decrease of asset or increase of liability are recognised by application of the recognition criteria stated above. Expenses are recognised in Profit & Loss A/c by matching them with the revenue generated. However, application of matching concept should not result in recognition of an item as asset (or liability), which does not meet the definition of asset or liability as the case may be.

Where economic benefits are expected to arise over several accounting periods, expenses are recognised in the Profit & Loss A/c on the basis of systematic and rational allocation procedures. The obvious example is that of depreciation.

An expense is recognised immediately in the Profit & Loss A/c when it does not meet or ceases to meet the definition of asset or when no future economic benefit is expected. An expense is also recognised in the Profit & Loss A/c when a liability is incurred without recognition of an asset, as is the case when a liability under a product warranty arises.

Example

Continuing with the same example given under para 1.8.4, suppose the trader had the following further transactions during the period:

(a) Wages paid Rs. 2,000.

(b) Rent outstanding Rs. 1,000

(c) Drawings Rs. 4,000.

Balance sheets of the trader after each transaction are shown below:

Transactions	*Assets* *Rs. lakh*	–	*Liabilities* *Rs. Lakh*	=	*Equity* *Rs. lakh*
Opening	5.00	–	2.00	=	3.00
(a) Capital introduced	5.20	–	2.00	=	3.20
(b) Income from investments	5.25	–	2.00	=	3.25
(c) Settlement of liability	4.95	–	1.69	=	3.26

(d)	Wages paid	4.93	–	1.69	=	3.24
(e)	Rent Outstanding	4.93	–	1.70	=	3.23
(f)	Drawings	4.89	–	1.70	=	3.19

The example given above explains the definition of expense. The equity decreased by Rs. 7,000 from Rs. 3.26 lakh to Rs. 3.19 lakh due to (i) Drawings Rs. 4,000 and (ii) expenses incurred Rs. 3,000 (Wages paid + Rent). Expenses are therefore decreases in equity without drawings. Also note that expenses incurred is accompanied by either decrease of asset (Cash paid for wages) or by increase in liability (Rent outstanding).

Note: The points discussed above leads us to the following relationships:

Let us take:

Closing equity = CE = Closing Assets (CA) – Closing Liabilities (CL)

Opening Equity = OE = Opening Assets (OA) – Opening Liabilities (OL)

Capital Introduced = C

Drawings = D

Income = I

Expenses = E

$CE = OE + C + (I – E) – D$

Or $CE = OE + C + Profit – D$

Or $Profit = CE – OE – C + D$

Or $Profit = (CA – CL) – (OA – OL) – C + D$

From above one can clearly see that profit depends on values of assets and liabilities. Since historical costs are mostly used for valuation, the reported profits are mostly based on historical cost conventions. The framework recognises other methods of valuation of assets and liabilities. The point to note that reported figures of profit change with the changes in the valuation basis. Conceptually, this is the foundation of idea of Capital Maintenance.

1.9 MEASUREMENT OF ELEMENTS IN FINANCIAL STATEMENTS

Measurement is the process of determining money value at which an element can be recognised in the balance sheet or statement of profit and loss. The framework recognises four alternative measurement bases for the purpose. These bases relate explicitly to the valuation of assets and liabilities. The valuation of income or expenses, i.e. profit is implied, by the value of change in assets and liabilities.

(i) Historical Cost

(ii) Current Cost

(iii) Realisable (Settlement) Value and

(iv) Present Value.

In preparation of financial statements, all or any of the above can be used in varying combinations to assign money values to financial items. A brief explanation of each follows.

1.9.1 Historical Cost : Historical cost means acquisition price. For example, the businessman paid Rs. 7,00,000 to purchase the machine, its acquisition price including installation charges is Rs. 8,00,000. The historical cost of machine would be Rs. 7,00,000.

According to this base, assets are recorded at an amount of cash or cash equivalent paid or the fair value of the asset at the time of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation. In some circumstances a liability is recorded at the amount of cash or cash equivalent expected to be paid to satisfy it in the normal course of business.

When one Mr. X a businessman, takes Rs. 5,00,000 loan from a bank @ 10% interest p.a., it is to be recorded at the amount of proceeds received in exchange for the obligation. Here the obligation is the repayment of loan as well as payment of interest at an agreed rate i.e. 10%. Proceeds received are Rs. 5,00,000 - it is historical cost of the transactions. Take another case regarding payment of income tax liability. You know every individual has to pay income tax on his income if it exceeds certain minimum limit. But the income tax liability is not settled immediately when one earns his income. The income tax authority settles it some time later, which is technically called assessment year. Then how does he record this liability? As per historical cost base it is to be recorded at an amount expected to be paid to discharge the liability.

Historical cost of an asset is cash or cash equivalent paid or fair value of other consideration given at the time acquisition of the asset. By historical cost convention liabilities are recorded the amount of proceeds received in exchange of the obligation or in some cases (for example liability for income tax) the amount that is likely to be paid for settlement of liability in the normal course of business.

Example

A machine was acquired in exchange of an old car and Rs. 20,000 paid in cash. The carrying amount of the car was Rs. 1,75,000. The fair value of the car on the date of exchange was Rs. 1,50,000. The accounting entry to record the exchange is suggested below:

	Rs.	Rs.	
Machinery	1,70,000		Rs. 1,50,000 + Rs. 20,000
Loss on disposal of Car	25,000		Rs. 1,75,000 – Rs. 1,50,000
To Car		1,75,000	Carrying amount
To Bank		20,000	

Historical cost of the machine = Fair value of car given on exchange + Cash paid

1.9.2 Current Cost : Current cost gives an alternative measurement base. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently. Take that Mr. X purchased a machine on 1st January, 1995 at Rs. 7,00,000. As per historical cost base he has to record it at Rs. 7,00,000 i.e. the acquisition price. As on 1.1.2006, Mr. X found that it would cost Rs. 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 1.1.95 Rs. 5,00,000 @ 18% p.a repayable at the end of 15th year together with interest. As on 1.1.2006 the bank announces 1% prepayment penalty on the loan amount if it is paid within 15 days starting from that day. As per historical cost the liability is recorded at Rs. 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at Rs. 7,00,000.

Example

A machine was acquired for $ 10,000 on deferred payment basis. The rate of exchange on the date of acquisition was Rs. 49/$. The payments are to be made in 5 equal annual instalments together with 10% interest per year. The current market value of similar machine in India is Rs. 5 lakh.

	Rs.	Rs.
Machinery	5,00,000	
To Deferred Payment Obligation		4,90,000
To Revaluation Reserves (Note 1)		10,000

Current cost of the machine = Current market price = Rs. 5,00,000.

By historical cost convention, the machine would have been recorded at Rs. 4,90,000.

To settle the deferred payment on current date one must buy dollars at Rs. 49/$. The liability is therefore recognised at Rs. 4,90,000 ($ 10,000 × Rs. 49). Note that the amount of liability recognised is not the present value of future payments. This is because, in current cost convention, liabilities are recognised at undiscounted amount.

Note 1: Paragraph 80 of the conceptual framework provides that revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the Profit & Loss A/c under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves.

1.9.3 Realisable (Settlement) Value: For assets, this is the amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business. As per realisable value, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the assets in *an orderly disposal*. Haphazard disposal may yield something less. Liabilities are carried at their settlement values; i.e. the undiscounted amount of cash or cash equivalents expressed to be paid to satisfy the liabilities in the normal course of business.

So the machine should be recorded at Rs. 20,00,000 the realisable value in an orderly sale while the bank loan should be recorded at Rs. 5,00,000 the settlement value in the normal course of business.

1.9.4 Present Value : Present value of an amount A, after n years is the amount P, one has to invest on current date to have A after n years. If the rate if interest is R:

$A = P(1 + R)^n$

Or P (Present value of A after n years) = $\frac{A}{(1+R)^n} = A \times \frac{1}{(1+R)^n}$

The process of obtaining present value of future cash flow is called discounting. The rate of interest used for discounting is called the discounting rate. The expression $[1/(1+R)^n]$, called discounting factor depends on values of R and n.

Let us take a numerical example assuming interest 10%, A = Rs. 11,000 and n = 1 year

$11{,}000 = 10{,}000(1 + 0.1)^1$

Or Present value of Rs. 11,000 after 1 year = $\frac{11{,}000}{(1{,}10)^1} = 11{,}000 \times \frac{1}{(1.10)^1}$

Or Present value of Rs. 11,000 after 1 year = 11,000 × 0.909 = Rs. 10,000

Note that a receipt of Rs. 10,000 (present value) now is equivalent of a receipt of Rs. 11,000 (future cash inflow) after 1 year, because if one gets Rs. 10,000 now he can invest to collect Rs. 11,000 after 1 year. Likewise, a payment of Rs. 10,000 (present value) now is equivalent of paying of Rs. 11,000 (future cash outflow) after 1 year.

Thus if an asset generates Rs. 11,000 after 1 year, it is actually contributing Rs. 10,000 at the current date if the rate of earning required is 10%. In other words the value of the asset is Rs.10, 000. which is the present value of net future cash inflow it generates.

If an asset generates Rs. 11,000 after 1 year, and Rs. 12,100 after two years, it is actually contributing Rs. 20,000 at the current date if the rate of earning required is 10% (Rs. 11,000 × 0.909 + Rs. 12,100 × 0.826). In other words the value of the asset is Rs. 20,000, i.e. the present value of net future cash inflow it generates.

Under present value convention, assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities under this convention are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

Example

Carrying amount of a machine is Rs. 40,000 (Historical cost less depreciation). The machine is expected to generate Rs. 10,000 net cash inflow. The net realisable value (or net selling price) of the machine on current date is Rs. 35,000. The enterprise's required earning rate is 10% per year.

The enterprise can either use the machine to earn Rs. 10,000 for 5 years. This is equivalent of receiving present value of Rs. 10,000 for 5 years at discounting rate 10% on current date. The value realised by use of the asset is called value in use. The value in use is the value of asset by present value convention.

Value in use = Rs. 10,000 (0.909 + 0.826 + 0.751 + 0.683 + 0.621) = Rs. 37,900

Net selling price = Rs. 35,000

The company should use the asset to realise Rs. 37,900

The value of the asset is Rs. 37,900, which is called its recoverable value. It is obviously not appropriate to carry any asset at a value higher than its recoverable value.

The asset is currently overstated by Rs. 2,100 (Rs. 40,000 – Rs. 37,900).

The overstatement of the asset is called impairment loss. The accounting entries to recognise the impairment loss and to bring down the asset to its recoverable value are suggested below:

	Rs.	Rs.
Impairment Loss	2,100	
To Machinery		2,100
Profit & Loss A/c	2,100	
To Impairment Loss		2,100

1.10 CAPITAL MAINTENANCE

Capital refers to net assets of a business. Since a business uses its assets for its operations, a fall in net assets will usually mean a fall in its activity level. It is therefore important for any business to maintain its net assets in such a way, as to ensure continued operations at least at the same level year after year. In other words, dividends should not exceed profit after appropriate provisions for replacement of assets consumed in operations. For this reason, the Companies Act does not permit distribution of dividend without providing for depreciation on fixed assets. Unfortunately, this may not be enough in case of rising prices. The point is explained below:

WE have already observed: P = (CA – CL) – (OA – OL) – C + D

Where: Profit = P

Opening Assets = OA and Opening Liabilities = OL

Closing Assets = CA and Closing Liabilities = CL

Introduction of capital = C and Drawings / Dividends = D

Retained Profit = P – D = (CA – CL) – (OA – OL) – C

Or Retained Profit = Closing Equity – (Opening Equity + Capital Introduced)

A business must ensure that retained profit (RP) is not negative, i.e. closing equity should not be less than capital to be maintained, which is sum of opening equity and capital introduced.

It should be clear from above that the value of retained profit depends on the valuation of assets and liabilities. In order to check maintenance of capital, i.e. whether or not retained profit is negative, we can use any of the following three bases.

Financial capital maintenance at historical cost : Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than zero, the capital is said to be maintained at historical costs.

This means the business will have enough funds to replace its assets at historical costs. This is quite right as long as prices do not rise.

Financial capital maintenance at current purchasing power : Under this convention, opening and closing equity at historical costs are restated at closing prices using average price indices. For example, suppose opening equity at historical cost is 3,00,000 and opening price index is 100. The opening equity at closing prices is Rs. 3,60,000 if closing price index is 120. A positive retained profit by this method means the business has enough funds to replace its assets at average closing price. This may not serve the purpose because in reality prices of all assets do not change at average rate. For example, price of a machine can increase by 30% while the average increase is 20%.

Physical capital maintenance at current costs: Under this convention, the historical costs of opening and closing assets are restated at closing prices using specific price indices applicable to each asset. The liabilities are also restated at a value of economic resources to be sacrificed to settle the obligation at current, i.e. closing date. The opening and closing equity at closing current costs are obtained as excess of aggregate of current cost values of assets over aggregate of current cost values of liabilities. A positive retained profit by this method ensures retention of funds for replacement of each asset at respective closing prices.

Example (Financial capital maintenance at historical costs)

A trader commenced business on 01/01/05 with Rs. 12,000 represented by 6,000 units of a certain product at Rs. 2 per unit. During the year 2005 he sold these units at Rs. 3 per unit and had withdrawn Rs.6, 000. Thus:

Opening Equity = Rs. 12,000 represented by 6,000 units at Rs. 2 per unit.

Closing Equity = Rs. 12,000 (Rs. 18,000 – Rs. 6,000) represented entirely by cash.

Retained Profit = Rs. 12,000 – Rs. 12,000 = Rs. 0

The trader can start year 2006 by purchasing 6,000 units at Rs. 2 per unit once again for selling them at Rs. 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

Example (Financial capital maintenance at current purchasing power)

In the previous example, suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

Opening Equity = Rs. 12,000 represented by 6,000 units at Rs. 2 per unit.

Opening equity at closing price

= (Rs. 12,000 / 100) x 120 = Rs. 14,400 (= 6,000 x Rs. 2.40)

Closing Equity at closing price

= Rs. 12,000 (Rs. 18,000 – Rs. 6,000) represented entirely by cash.

Retained Profit = Rs. 12,000 – Rs. 14,400 = (-) Rs. 2.400

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs. 12,000 is not sufficient to buy 6,000 units again at increased price Rs. 2.40 per unit. In fact, he should have restricted his drawings to Rs. 3,600 (Rs. 6,000 – Rs. 2,400).

Had the trader withdrawn Rs. 3,600 instead of Rs. 6,000, he would have left with Rs. 14,400, the fund required to buy 6,000 units at Rs. 2.40 per unit.

Example (Physical capital maintenance)

In the previous example, suppose that the price of the product at the end of year is Rs. 2.50 per unit. In other words, the specific price index applicable to the product is 125.

Current cost of opening stock = (Rs. 12,000 / 100) x 125 = 6,000 x Rs. 2.50 = Rs. 15,000

Current cost of closing cash = Rs. 12,000 (Rs. 18,000 – Rs. 6,000)

Opening equity at closing current costs = Rs. 15,000

Closing equity at closing current costs = Rs. 12,000

Retained Profit = Rs. 12,000 – Rs. 15,000 = (-) Rs. 3,000

The negative retained profit indicates that the trader has failed to maintain his capital. The available fund Rs. 12,000 is not sufficient to buy 6,000 units again at increased price Rs. 2.50 per unit. The drawings should have been restricted to Rs. 3,000 (Rs. 6,000 – Rs. 3,000).

Had the trader withdrawn Rs. 3,000 instead of Rs. 6,000, he would have left with Rs. 15,000, the fund required to buy 6,000 units at Rs. 2.50 per unit.

The three ideas of capital maintenance are summarised below for convenience

Financial Capital Maintenance at historical costs

	Rs.	*Rs.*
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		

Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	Nil	12,000
Retained profit		Nil

Financial Capital Maintenance at current purchasing power

	Rs.	*Rs.*
Closing capital (At closing price)		12,000
Less: Capital to be maintained		
Opening capital (At closing price)	14,400	
Introduction (At closing price)	Nil	14,400
Retained profit		(2,400)

Physical Capital Maintenance

	Rs.	*Rs.*
Closing capital (At current cost)		12,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	Nil	15,000
Retained profit		(3.000)

***Reference* : Text of the " Framework for the Preparation and Presentation of Financial Statements" issued by the Accounting Standards Board of the Institute of Chartered Accountants of India given in appendix I..**

Self-Examination Questions

I Objective type questions

Choose the most appropriate answer from the given options:

1. All of the following are fundamental accounting assumptions except

   (a) Accrual.

(b) Going concern.

(c) Consistency.

(d) Business entity.

2. Two primary qualitative characteristics of financial statements are

   (a) Understandability and materiality.

   (b) Relevance and reliability.

   (c) Relevance and understandability.

   (d) Materiality and reliability

3. It is essential to standardize the accounting principles and policies in order to ensure

   (a) Transparency.

   (b) Consistency.

   (c) Comparability.

   (d) All of the above.

4. Financial statements show

   (a) Results of business entity over a period of time.

   (b) Financial information of business entity as on a particular date.

   (c) Portray the financial effects of past events.

   (d) All of the above.

[**Ans.1(i)** (d); **2**. (c); **3**. (d); **4**. (d)]

II Short answer type questions

5. What are the objectives of preparing financial statements? Discuss.

6. What is meant by "Fundamental accounting assumptions"? Explain in brief.

7. Write short note on historical basis of valuation.

8. Write short note on Consistency.

9. Discuss the fundamental accounting assumptions.

III Long answer type questions

10. Define capital maintenance. Explain physical and financial capital maintenance in detail with the help of an example.

11. . Explain the purpose and status of the conceptual framework for the preparation and presentation of financial statements in brief.

12. What are the qualitative characteristics of financial statements? Discuss in detail.

13. Describe the elements of financial statements.

IV Practical Problem

14. A proprietor, Mr. A has reported a profit of Rs. 1,25,000 at the end of the financial year after taking into consideration the following amount:

    (i) The cost of an asset of Rs. 25,000 has been taken as en expense.

    (ii) Mr. A is anticipating a profit of Rs. 10,000 on the future sale of a car shown as an asset in his books.

    (iii) Salary of Rs. 7,000 payable in the financial year has not been taken into account.

    (iv) Mr. A purchased an asset for Rs.75,000 but its fair value on the date of purchase was Rs. 85,000. Mr. A recorded the value of asset in his books by Rs. 85,000.

    On the basis of the above facts answer the following questions from the given choices:

    (i) What is the correct amount of profit to be reported in the books?

    (a) Rs. 1,25,000, (b) Rs.1,35,000, (c) Rs. 1,50,000,(d) Rs. 1,33,000,

    (ii) Which measurement base should be followed in the statement (iv)?

(a) Historical cost,(b) Current cost (c) Replacement cost (d)Present value

(iii) Which concept should be followed in the statement (ii)?

(a) Conservatism, (b) Materiality, (c) Historical cost, (d)Accrual,

(iv) Which concept should be followed in the statement (iii)?

(a) Materiality, (b) Historical cost, (c) Current cost, (d)Accrual,

[**Ans. (i)** (d); **(ii)** (a); **(iii)** (b); **(iv)** (d),]

CHAPTER 2

ACCOUNTING STANDARDS

Learning objectives

After studying this chapter, you will be able to:

- Understand the provisions of the given Accounting Standards.
- Solve the practical problems based on application of Accounting Standards.

1. INTRODUCTION

Accounting Standards (ASs) are written policy documents issued by expert accounting body or by government or other regulatory body covering the aspects of recognition, measurement, presentation and disclosure of accounting transactions in the financial statements. The accounting standards aim at improving the quality of financial reporting by promoting comparability, consistency and transparency, in the interests of users of financial statements. Good financial reporting not only promotes healthy financial markets, it also helps to reduce the cost of capital because investors can have faith in financial reports and consequently perceive lesser risks. You must have already studied the concept, objectives, benefits and limitations, applicability and compliance of Accounting Standards, in detail, in Chapter 1 of "Accounting" ATC Study Material – Group I.

2. OVERVIEW

2.1 CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE (AS 4)

Accounting Standard 4, Contingencies and Events Occurring after the Balance Sheet Date covers accounting treatment of (i) contingencies and (ii) events occurring after the balance sheet date. The standard was originally issued in November 1982. Later it was revised and the revised standard is mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1995. From April 1, 2004 i.e. the date from which the Accounting Standard 29, which covers accounting for contingencies, came into effect, all paragraphs of Accounting Standard 4, that deal with contingencies stand withdrawn, except for the limited purpose of provisioning for doubtful debts. It is important to note the reasons for keeping the requirements of AS 4 on contingencies alive for the limited purpose of provisioning for doubtful debts.

Contingencies are conditions, e.g. a damage suit filed against the enterprise, existing on balance sheet date, the outcome of which depends on uncertain future event. The outcome of a contingency can be favourable, e.g. when the enterprise gets a favourable decision in a damage suit filed by it against suppliers and recovers the damages, or unfavourable, e.g. when a Court orders the enterprise to pay damages in a damage suit filed against it by its customers. Recognition of possible favourable outcomes, called Contingent Assets, imply anticipation of gains and are ignored in preparation of financial statements on consideration of prudence. Depending on the degree uncertainty, a possible unfavourable outcome may either be provided for by a charge against profit or may be disclosed as contingent liability by way of a note. The Accounting Standard 4, prescribed rules for identifying the cases requiring creation of provision by charge against profit and the cases requiring disclosures as contingent liabilities.

A possible unfavourable outcome can take either the form of (i) possible fall in value of assets, e.g. fall in value of debtors due to possible bad debts or fall in value of fixed assets due to possible fall in efficiency or usefulness of the asset or (ii) origination of obligation, e.g. possibility of a damage becoming payable. The contingencies that may result in obligations are currently covered by AS 29 (except the cases covered by other accounting standards, e.g. provision for tax covered by AS 22) and hence requirements of AS 4 as regards contingencies to that extent have become inoperative. The cases of contingencies that may result in diminution in value of assets are out of scope of AS 29 because rules for creating provision for diminution in value of assets are already covered by other accounting standards, e.g. AS 6, Depreciation Accounting and AS 28 Impairment of Assets. The only diminution in value of only asset that is now left uncovered by any accounting standard is the debtors. A new Accounting Standard on Financial Instruments: Recognition and Measurement, which is under preparation, is expected to cover this aspect. Till the time the new standard is issued, it has been announced that the Doubtful Debts should be dealt in accordance with relevant paragraphs of AS 4, otherwise withdrawn.

Being currently applicable for the limited purpose of provisioning for doubtful debts, the relevant paragraphs of AS 4 dealing with contingencies are discussed below in brief. A detailed discussion of paragraphs of AS 4 dealing with Events Occurring after the Balance Sheet Date is however necessary.

Paragraph 3 of AS 4 defines contingencies as a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on occurrence, or the non-occurrence, of one or more uncertain future events.

As per paragraph 10 of AS 4, the amount of contingent loss should be provided for by a charge in the statement of profit and loss if:

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred (see note) as at the balance sheet date, and

(b) a reasonable estimate of the amount of resulting loss can be made.

The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of loss is remote. (Paragraph 11)

Events Occurring after Balance Sheet Date

Transactions are financial events. It is obvious that all financial events upto the balance sheet date should be taken into consideration in preparation of financial statements for an accounting period. Certain significant events may however occur after the balance sheet date, the knowledge of which is important for making assessment of performance and affairs of the reporting enterprise during the accounting period and also for making projections for the future. It is clearly important to communicate such events to the users of financial statements as far as possible. It is impractical to require enterprises to report events after approval of financial statements because such a requirement necessitates fresh approval of financial statements and thus starts an endless cycle of change of report and fresh approval.

Paragraph 3 of the standard define that events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in case of companies and by the corresponding approving authority in case of other entities.

The events occurring after the balance sheets can be reported either by (i) making appropriate adjustments in the financial statements or (ii) through report of the approving authority, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities.

Adjusting Events

An event after the balance sheet may require adjustment of reported values of assets, liability, expenses, income and equity for the accounting period, if the event is such as to provide further evidence of conditions that existed at the balance sheet date. Such events are adjusting events. For example, if a fraud during the accounting period is detected after the balance sheet date but before approval of the financial statement, it is necessary to recognise the loss and change the reported values concerned elements of financial statement. (Paragraph 13)

Example 1

A Ltd., whose accounting year ends on 31/03/05, agreed in principle to sell a plot of land on 18/03/05 at a price to be determined by an independent valuer. Pending the agreement for sale and due to non-receipt of valuers report, the sale of the land could not be completed up to 31/03/05. The company received the report on April 7 2005 and the agreement was signed on April 10, 2005. The financial statements for 2004-05 were approved by the board on May 12, 2005.

The sale of land, is an event occurring after the balance sheet date. Also, the condition, which led to the sell, existed on the balance sheet date. The signing of the agreement provides further evidence as to the condition that existed on the balance sheet date. The sell of land after the balance sheet date is therefore an adjusting event, which means the sale transaction should be recorded in books of A Ltd. for the purpose of its financial statement for 2004-05.

Non-adjusting events

Events after balance sheet date may result from conditions arising subsequent to the balance sheet date. Such events do not justify change in the reported values of assets, liabilities, expenses, income or equity. Such events, if they represent material changes and commitments affecting financial position of the enterprise, should be disclosed in the report of approving authority, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities. For example, an announcement after balance sheet date but before approval of financial statement, of a formal plan to discontinue an operation does not justify adjustment of financial statement of the accounting period already over, but is indicative of material change in future. Such events should be disclosed in the report of approving authority (Paragraph 15).

As per paragraph 17 of the standard, in reporting non-adjusting events, the directors (or other approving authority, as the case may be) should state the nature of the event along with their estimate of financial effect of the event. Where estimate of financial effect cannot be made, the report should state the fact that such an estimate cannot be made.

Example 2

An earthquake destroyed a major warehouse of C Ltd. on April 20, 2005. The last accounting year of the company ended on 31/03/05 and the financial statements for the year were approved on May 8, 2005. The destruction of warehouse is a significant event occurring after the balance sheet date, but since the earthquake did not exist on the balance sheet date, the destruction by earthquake is a non-adjusting event. The value of property lost by earthquake therefore need not be recognised in financial statement of 2004-05.

The Report of the Directors for 2004-05 should disclose the fact of earthquake together with an estimate of loss on earthquake. If no estimate of loss can be made, the report should state that loss on earthquake could not be estimated.

Example 3

A company follows April-March as its financial year. The company recognizes cheques dated 31 March or before, received from customers after balance sheet date but before approval of financial statement by debiting Cheques in hand A/c and crediting the Debtors A/c. The Cheques in hand is shown in balance sheet as an item of cash and cash equivalents. All Cheques in hand are presented to bank in the month of April and are also realised in the same month in normal course after deposit in the bank.

Even if the cheques bear the date 31 March or before, the cheques received after 31 March do not represent any condition existing on 31 March. Thus the collection of cheques after balance sheet date is not an adjusting event. Recognition of cheques in hand is therefore not consistent with requirements of AS 4. Moreover, the collection of cheques after balance sheet date does not represent any material change or commitments affecting financial position of the enterprise, and so no disclosure of such collections in the Directors' Report is necessary.

It should also be noted that, the Framework for Preparation and Presentation of Financial Statement defines assets as resources controlled by an enterprise as a result of past events from which economic benefits are expected to flow to the enterprise. Since the company acquires custody of the cheques after 31 March, it does not have any control over the cheques on 31 March and hence cheques in hand do not qualify to be recognized as asset on 31 March.

Exception to rule : events indicating going concern assumption inappropriate

As per paragraph 13 of the standard, an event occurring after the balance sheet date shall be an adjusting event even if it does not reflect any condition existing on the balance sheet date, if the event is such as to indicate that the fundamental accounting assumption of going concern is no longer appropriate.

Suppose a fire occurred in the factory and office premises of an enterprise after 31/03/05 but before approval of financial statement of 2004-05. The loss on fire is of such a magnitude that it is not reasonable to expect the enterprise to start operations again. Since the fire occurred after 31/03/05, the loss on fire is not a result of any condition existing on 31/03/05. Yet, the loss should be recognised in the statement of profit and loss for 2004-05 and the assets lost should be written off from the balance sheet dated 31/03/05.

Proposed Dividend

The directors propose dividends after balance sheet date for the obvious reason that no dividend can be proposed till the year is over and profit is ascertained. The dividends proposed by the directors however, do not reflect any condition existing on the balance sheet date. Yet, as per paragraph 14 of the standard, the proposed dividend should be treated as adjusting event, i.e. dividend proposed should be incorporated in the statement of profit and loss for the year as appropriation of profit and be recognised in balance sheet as provision.

2.2 NET PROFIT OR LOSS FOR THE PERIOD,PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES (AS 5)

The items of income/gains and expenses/losses recognised in a statement of profit and loss differ in financial implications. Some of them can be irregular, e.g. profit/loss on disposal of fixed assets, some can be rare, e.g. losses on fire, some can be adjustments for prior period errors. There can also be certain items reflecting changes in accounting policies and estimates, rather than an actual transaction. Financial implications of these are not same. For example, one can reasonably expect profit / loss from ordinary activities like purchases and sale of goods by a trader, to recur in future. This is definitely not true for profit/loss on disposal of fixed assets. Also, increase in profit due to expenses saved is not same as increase in profit due to change in depreciation methods.

Accounting standard 5, prescribes classification and disclosure requirements for items of income/gains and expenses/losses recognised in a statement of profit and loss. For the purpose, AS 5 puts items recognised in statements of profit and loss six broad groups viz (i) Ordinary (ii) Ordinary but exceptional (iii) Extra-ordinary (iv) Prior period items (v) Changes in accounting policies (vi) Changes in accounting estimates. The presentation and disclosure requirements are such that special nature of an item is apparent to the reader of financial statement. For example,

By setting a uniform basis of preparation and presentation of statements of profit and loss, the AS 5 improves comparability financial statements of same enterprise of different accounting periods and of different enterprises for same accounting period.

The Accounting Standard 5 was first issued in November 1982 and was titled 'Prior Period and Extraordinary Items and Changes in Accounting Policies'. Later, the standard was revised and the revised standard came into effect in respect of accounting periods commencing on or after April 1, 1996. The standard is mandatory and applies to all enterprises.

The important requirements regarding different items are as below:

Ordinary Activities

These are activities undertaken by an enterprise as part of its business and such other related activities in which the enterprise engages itself in furtherance of, incidental to, or arising from these activities. (Paragraph 4)

Where income or expenses arise out of ordinary activities but are of exceptional size, nature or incidence, they should be disclosed as separate line item in the statement of profit and loss. (Paragraph 12).

Circumstances, which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12, include**:**

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions

Extraordinary Items

These are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. (Paragraph 4)

The extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. (Paragraph 8)

Prior Period Items

These are income or expenses, which arise, in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods. (Paragraph 4) The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g. arrears payable to workers in current period as a result of retrospective revision of wages.

The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived. (Paragraph 15)

The prior period items are normally included in determination of net profit or loss for the current period. Alternatively, where the prior period items are not taken in computation of current profit, they can be added (or deducted as the case may be) from the current profit In either case, the disclosure should be such as to clearly show the effects of such items. (Paragraph 19)

Changes in Accounting Estimates

The students are aware that many items of financial statements, e.g. provision for doubtful debts and depreciation, are estimates rather than precise measures.

As per paragraph 23 of the standard, the change in accounting estimate should be included in the determination of net profit or loss in:

(a) the period of change, if the change affects the period only; or

(b) the period of change and the future periods, if the change affects both.

A change in estimate for doubtful debts affects current period only, while a change in estimated working life of a depreciable asset affects current as well as future periods.

The effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. (Paragraph 25)

If the change of accounting estimate affects an item previously classified as extraordinary item, the effect of change should also be taken as extraordinary item.

The nature and amount of change in accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed. (Paragraph 27)

Example 1

An extract from the statement profit and loss of a company for 2007-08 is given below:

	Rs. 000	Rs. 000
Sales		3,000
Opening stock	500	
Production cost	2,800	
	3,300	
Less: Closing Stock	600	2,700
Gross Profit		300

Expenses	250
Profit before tax	50
Tax	20
Profit after tax	30

The closing stock includes stock damaged in a fire in 2006-07. On 31/03/07, the estimated net realisable value of this stock was Rs. 15,000. The revised estimate of net realisable value included in closing stock of 2007-08 is Rs. 5,000.

Rewrite the statement of profit and loss if necessary to comply with requirements of AS 5.

Solution

The fall in estimated net realisable value of damaged stock Rs. 10,000 is the effect of change in accounting estimate. As per paragraph 25 of the standard, the effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

The difference between cost of the stock and its net realisable value after fire was presumably classified as loss on fire in 2006-07. The loss on fire is an extraordinary item. Since paragraph 25 does not permit change in classification, the fall in net realisable value of damaged stock Rs. 10,000 should be classified as extra ordinary item in 2007-08 as well.

Paragraph 8 of the standard requires the extraordinary items to be disclosed in such manner that their impact on current profit or loss can be perceived. To comply with this requirement, enterprises should present profit/loss before and after extraordinary items.

	Rs. 000	Rs. 000
Sales		3,000
Opening stock (500 – 15)	485	
Production cost	2,800	
	3,285	
Less: Closing Stock (600 – 5)	595	2,690
Gross Profit		310
Expenses		250
Profit before loss on fire		60

Less: Loss on fire	10
Profit before tax	50
Tax	20
Profit after tax	30

Accounting Policies

These are specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements. A change in accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.

As per paragraph 32 of the standard, any material effect of change in accounting policy should be disclosed in the financial statement. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of change in accounting policy is not ascertainable, the fact should be indicated. Where the change does not have any material effect in current period, but is reasonably expected to materially affect the later periods, the fact of change should be appropriately disclosed in the current period.

As per paragraph 22 of the standard, sometimes it is difficult to distinguish between change in accounting policy and change in accounting estimate. In such cases the change is treated as change in accounting estimate, with appropriate disclosure.

Example 2

Cost of a machine acquired on 01/04/04 was Rs. 1,00,000. The machine is expected to realise Rs. 5,000 at the end of its working life of 10 years. Straight-line depreciation of Rs. 9,500 per year has been charged upto 2005-06. For and from 2006-07, the company switched over to 17% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 13 years. The new rate shall apply with retrospective effect from 01/04/04. (See AS 6)

Solution

WDV of asset at the end of 2005-06 = Rs. 1,00,000 – Rs. 9,500 x 2 = Rs. 81,000

WDV of asset at the end 2005-06 (by reducing balance method)

$$= \text{Rs. } 1{,}00{,}000\ (1 - 0.17)^2 = \text{Rs. } 68{,}890$$

Depreciation to be charged in 2006-07

= (Rs. 81,000 – Rs. 68,890) + 17% of Rs. 68,890 = Rs. 23,821

In this example, the revision of remaining useful life is change in accounting estimate, and adoption of reducing balance method of depreciation instead of the straight-line method is change in accounting policy. Since it is difficult to segregate impact of these two changes, the entire amount of difference between depreciation at old rate and depreciation charged in 2006-07 (Rs. 23,821 – Rs. 9,500 = Rs. 14,321) is regarded as effect of change in accounting estimate as per paragraph 22 of the standard.

2.3 ACCOUNTING STANDARD 11: THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

AS 11, (revised 2003), comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

Scope

This Statement should be applied:

(a) In accounting for transactions in foreign currencies.

(b) In translating the financial statements of foreign operations.

(c) This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Statement does not:

(a) Specify the currency in which an enterprise presents its financial statements.

(b) Deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation.

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

A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

(a) Buys or sells goods or services whose price is denominated in a foreign currency.

(b) Borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency.

(c) Becomes a party to an unperformed forward exchange contract or

(d) Otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

Initial Recognition

A foreign currency transaction on initial recognition should be recorded by applying the foreign currency at the date of the transaction. A rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

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

Non-monetary items are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares.

At each balance sheet date:

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

(b) Non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction.

(c) Non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

(d) The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences

Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Example

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/2006, which will be repaid as on 31/07/2006. X Ltd. prepares financial statement ending on 31/03/2006. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2006	1 US$ = Rs. 48.00
31/03/2006	1 US$ = Rs. 49.00
31/07/2006	1 US$ = Rs. 49.50

Solution

Journals in the Books of Kalim Ltd.

Date	*Particulars*		*Rs. (Dr.)*	*Rs. (Cr.)*
Jan. 01, 2006	Bank Account (4,50,000 x 48)	Dr.	21,60,000	
	To Foreign Loan Account			21,60,000
Mar. 31, 2006	Foreign Exchange Difference Account	Dr.	4,50,000	
	To Foreign Loan Account [4,50,000 x (49 - 48)]			4,50,000
Jul. 01, 2006	Foreign Exchange Difference Account	Dr.	2,25,000	
	Foreign Loan Account	Dr.	26,10,000	
	To Bank Account			28,35,000

Foreign operation is a subsidiary, associate, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations.

Translation of Foreign Integral Operations

The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

Non-integral foreign operation is a foreign operation that is not an integral foreign operation. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

a The assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

b Income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

c All resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

d For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

e Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate.

f A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

g The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary. However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations.

h When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise.

i The exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

j An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

a While the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise.

b Transactions with the reporting enterprise are not a high proportion of the foreign operation's activities.

c The activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise.

d Costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency.

e The foreign operation's sales are mainly in currencies other than the reporting currency.

f Cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation.

g Sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation.

h There is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

<u>Change in the Classification of a Foreign Operation</u>

When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

Example

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Head Office and Branch as at 31.03.2006:

Account Name	*Amount in £*	
	Dr.	*Cr.*
Fixed Assets (Purchased on 01.04.2003)	5,000	
Debtors	1,600	
Opening Stock	400	
Goods received from Head Office Account	6,100	
(Recorded in HO books as Rs. 4,02,000)		
Sales		20,000

Purchases	10,000	
Wages	1,000	
Salaries	1,200	
Cash	3,200	
Remittances to Head Office (Recorded in HO books as Rs. 1,91,000)	2,900	
Head Office Account (Recorded in HO books as Rs. 4,90,000)		7,400
Creditors		4,000

- Closing stock at branch is £ 700 on 31.03.2006.
- Depreciation @ 10% p.a. is to be charged on fixed assets.
- Prepare the trial balance after been converted in Indian Rupees.
- Exchange rates of Pounds on different dates are as follow:
  01.04.2003– Rs. 61; 01.04.2005– Rs. 63 & 31.03.2006 – Rs. 67

Solution

Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 2008

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	Rs. (Dr.)	Rs. (Cr.)
Fixed Assets	5,000		Transaction Date Rate	305,000	
Debtors	1,600		Closing Rate	107,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	402,000	
Sales		20,000	Average Rate		1,300,000
Purchases	10,000		Average Rate	650,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	214,400	
Remittance to HO	2,900		Actuals	191,000	
HO Account		7,400	Actuals		490,000
Creditors		4,000	Closing Rate		268,000
Exchange Rate Difference			Balancing Figure		
	31,400	31,400		2,037,800	2,058,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

Forward exchange contract means an agreement to exchange different currencies at a forward rate.

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

An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Example

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 2006, payable after three months. Company entered into a forward contract for three months @ Rs. 49.15 per dollar. Exchange rate per dollar on 01st Feb. was Rs. 48.85. How will you recognize the profit or loss on forward contract in the books of Rau Ltd.

Solution:

Forward Rate	Rs. 49.15
Less: Spot Rate	Rs. 48.85
Premium on Contract	Rs. 0.30
Contract Amount	US$ 1,00,000
Total Loss (1,00,000 x 0.30)	Rs. 30,000

Contract period 3 months

Two falling the year 2006-07; therefore loss to be recognized (30,000/3) x 2 = Rs. 20,000.

Rest Rs. 10,000 will be recognized in the following year.

Example

Mr. A bought a forward contract for three months of US$ 1,00,000 on 1st December at 1 US$ = Rs. 47.10 when exchange rate was US$ 1 = Rs. 47.02. On 31st December when he closed his books exchange rate was US$ 1 = Rs. 47.15. On 31st January, he decided to sell the contract at Rs. 47.18 per dollar. Show how the profits from contract will be recognized in the books.

Solution:

Since the forward contract was for speculation purpose the premium on contract i.e. the difference between the spot rate and contract rate will not be recorded in the books. Only when the contract is sold the difference between the contract rate and sale rate will be recorded in the Profit & Loss Account.

Sale Rate	Rs. 47.18
Less: Contract Rate	Rs. 47.10
Premium on Contract	Rs. 0.08
Contract Amount	US$ 1,00,000
Total Profit (1,00,000 x 0.08)	Rs. 8,000

Disclosure

An enterprise should disclose:

a. The amount of exchange differences included in the net profit or loss for the period.

b. Net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

Change in classification of a significant foreign operation

When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

a. The nature of the change in classification;

b. The reason for the change;

c. The impact of the change in classification on shareholders' funds; and

d. The impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

2.4 ACCOUNTING FOR GOVERNMENT GRANTS (AS 12)

The Standard comes into effect in respect of accounting periods commencing on or after 1.4.1992 and will be recommendatory in nature for an initial period of two years.

Introduction

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

This Statement does not deal with:

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

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

iii. Government participation in the ownership of the enterprise.

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

Accounting Treatment

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

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

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

ii. They are not earned but represent an incentive provided by government without related costs.

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

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

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

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

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

Recognition of Government Grants

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

i. Where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

ii. Where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

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

Non-monetary Government Grants

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

Presentation of Grants Related to Specific Fixed Assets

Two methods of presentation in financial statements of grants related to specific fixed assets are regarded as acceptable alternatives.

Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.

Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Example

Z Ltd. purchased a fixed asset for Rs. 50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs. 5,00,000. On purchase of the assets government granted it a grant for Rs. 10 lakhs. Pass the necessary journal entries in the books of the company for first two years.

Solution:

Journal in the books of Z Ltd.

Year	Particulars	Rs. (Dr.)	Rs. (Cr.)
1st	Fixed Assets Account Dr.	5,000,000	
	To Bank Account		5,000,000
	(Being Fixed Assets purchased)		
	Bank Account Dr.	1,000,000	
	To Fixed Assets Account		1,000,000
	(Being grant received from the government)		
	Depreciation Account Dr.	700,000	
	To Fixed Assets Account		700,000
	(Being Depreciation charged on SLM)		
	Profit & Loss Account Dr.	700,000	
	To Depreciation Account		700,000
	(Being Depreciation transferred to P/L Account)		
2nd	Depreciation Account Dr.	700,000	
	To Fixed Assets Account		700,000
	(Being Depreciation charged on SLM)		
	Profit & Loss Account Dr.	700,000	
	To Depreciation Account		700,000
	(Being Depreciation transferred to P/L Account)		

Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.

Example

Z Ltd. purchased a fixed asset for Rs. 50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs. 5,00,000. On purchase of the assets government granted it a grant for Rs. 10 lakhs. Pass the necessary journal entries in the books of the company for first two years.

Solution:

Journal in the books of Z Ltd.

Year	**Particulars**	Rs. (Dr.)	Rs. (Cr.)
1st	Fixed Assets Account Dr.	5,000,000	
	To Bank Account		5,000,000
	(Being Fixed Assets purchased)		
	Bank Account Dr.	1,000,000	
	To Deferred Govt. Grant Account		1,000,000
	(Being grant received from the government)		
	Depreciation Account Dr.	700,000	
	To Fixed Assets Account		700,000
	(Being Depreciation charged on SLM)		
	Profit & Loss Account Dr.	700,000	
	To Depreciation Account		700,000
	(Being depreciation transferred to P/L Account)		
	Deferred Govt. Grants Account Dr.	200,000	
	To Profit & Loss Account		200,000
	(Being proportionate government grant taken to P/L Account)		
2nd	Depreciation Account Dr.	700,000	
	To Fixed Assets Account		700,000
	(Being Depreciation charged on SLM)		

Profit & Loss Account Dr.	700,000	
To Depreciation Account		700,000
(Being depreciation transferred to P/L Account)		
Deferred Govt. Grant Account Dr.	200,000	
To Profit & Loss Account		200,000
(Being proportionate government grant taken to P/L Account)		

Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

Presentation of Grants Related to Revenue

Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

Presentation of Grants of the nature of Promoters' contribution

Where the government grants are of the nature of promoters' contribution, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

Refund of Government Grants

Government grants sometimes become refundable because certain conditions are not fulfilled and is treated as an extraordinary item (AS 5).

The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable.

Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

Example

Z Ltd. purchased a fixed asset for Rs. 50 lakhs, which has the estimated useful life of 5 years with the salvage value of Rs. 5,00,000. On purchase of the assets government granted it a grant for Rs. 10 lakhs. Grant was considered as refundable in the end of 2nd year to the extent of Rs. 7,00,000. Pass the journal entry for refund of the grant.

Solution:

Fixed Assets Account Dr.	7,00,000	
To Bank Account		7,00,000
(Being government grant on asset refunded)		

Example

Z Ltd. purchased a land for Rs. 50 lakhs. On purchase of the assets government granted it a grant for Rs. 10 lakhs. Grant was considered as refundable in the end of 2nd year to the extent of Rs. 7,00,000. Pass the journal entry for refund of the grant.

Solution:

Deferred Govt. Grant Account Dr.	6,00,000	
Profit & Loss Account Dr.	1,00,000	
To Bank Account		7,00,000
(Being government grant on asset refunded)		

Disclosure

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

ii. The nature and extent of government grants recognized in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.

2.5 ACCOUNTING STANDARD 16: BORROWING COSTS

This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. It does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

Borrowing costs may include:

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

b. Amortisation of discounts or premiums relating to borrowings;

c. Amortisation of ancillary costs incurred in connection with the arrangement of borrowings;

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

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

A *qualifying asset* is an asset that necessarily takes a substantial period of time [2] to get ready for its intended use or sale.

Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

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

It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

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

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

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

Commencement of Capitalisation

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

a. Expenditure for the acquisition, construction or production of a qualifying asset is being incurred: Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset. The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

b. Borrowing costs are being incurred.

c. Activities that are necessary to prepare the asset for its intended use or sale are in progress: The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place.

Suspension of Capitalisation

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale.

Cessation of Capitalisation

Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.

Disclosure

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

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

2.6 LEASES (AS 19)

Lease is an agreement between owner of an asset (lessor) to grant the right of use of it to another party, called the lessee for specified period, in consideration of specified periodic payments, called the lease rents. The leasing may in effect be same as hire purchase because the ownership of the asset can be transferred to the lessee for a small sum at the termination of lease agreement. Prior to issuance of the Accounting Standard (AS) 19, Leases, by the Institute of Chartered Accountants of India, all leases were treated as a mode of off-balance sheet finance. This allowed enterprises not to recognise assets taken on lease in their balance sheets and thus to understate their net assets and capital employed and consequently to overstate their return on investment (ROI). The Accounting Standard (AS) 19, Leases, has reduced the scope of this kind of window dressing by requiring enterprises to recognise assets taken on certain types of leases, called finance leases. The finance leases are those, in which risks and rewards of ownership are substantially transferred from the lessor to lessee.

The policy of recognition of assets taken on finance lease is an example of principle of 'substance over form' described in paragraph 17 of Accounting Standard (AS) 1, Disclosure of Accounting Policies. By the principle of 'substance over form' in selecting accounting policies, enterprises are required to give precedence to substance of a transaction over its legal form. In case of finance leases, the lessee, despite not being legal owner, effectively enjoys all rights and accepts all liabilities, usually attached with ownership. It is therefore rational for the lessee to recognise the assets taken on finance leases as assets in its books.

It may also be mentioned that the paragraph 49(a) of the Framework for the Preparation and Presentation of Financial Statement (issued 2000), defines assets as 'resources controlled by an enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.' It should thus be clear that necessary condition for recognition of an asset is existence of control rather than ownership. The policy of recognition of assets taken on finance leases is therefore consistent with the definition of asset as per the Framework, aforesaid.

Applicability of Accounting Standard

The Accounting Standard (AS) 19, Leases came into effect in respect of all assets leased during accounting periods commencing on or after April 1, 2001 and was declared mandatory from that date. The standard applies to all enterprises. The Level II and Level III enterprises are however exempted from making certain disclosures. (See the Scheme for Applicability of Accounting Standards) Any enterprise that does not make disclosures in pursuance of this exemption, should disclose that fact.

The standard applies to all leases other than: (Paragraph 1, AS 19)

(a) lease agreements to explore for or use of natural resources, such as oil, gas, timber metals and other mineral rights; and

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

(c) lease agreements to use lands

Types of leases

For accounting purposes, leases are classified as (i) *finance leases* and (ii) *operating leases*. A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. An operating lease is a lease other than finance lease.

Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Paragraph 8 of the standard gives examples of certain situations, which would normally lead to a lease being classified as a finance lease. These are:

(a) The lease transfers ownership of the asset to the lessee by the end of the lease term; (these situations may commonly arise in hire purchase)

(b) The lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) The lease term is for the major part of the economic life of the asset even if title is not transferred; (Under US GAAP, a threshold limit of 75% or more of economic life is set. See details at the end of chapter)

(d) At the inception of the lease, present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; (Under US GAAP, a threshold limit of 90% or more of fair value is set. See details at the end of chapter) and

(e) The leased asset is of a specialized nature such that only the lessee can use it without major modifications being made.

Paragraph 9 of the standard describes certain situations, which individually or in combination may indicate that the concerned lease is a finance lease. These are:

(a) If the lessee can cancel the lease and the lessor's losses associated with the cancellation are borne by the lessee;

(b) If gains or losses from the fluctuations in the residual value accrue to the lessee (for example if the lessor agrees to allow rent rebate equaling most of the disposal value of leased asset at the end of the lease); and

(c) If the lessee can continue the lease for a secondary period at a rent, which is substantially lower than market rent.

Lease Payments

Lease payments may consist of specified periodic payments, called lease rents and a terminal payment, called the guaranteed residual value. Together, these payments are called the minimum lease payments. The excess of expected residual value over the guaranteed residual value is the unguaranteed residual value. Contingent rents are lease payments based on a factor other than passage of time, e.g. percentage sales, amount of usage etc.

Accounting for finance leases (Books of lessee)

Since risks and rewards of ownership are substantially transferred, a finance lease should be viewed as an agreement by which the lessor lends the fair value of the leased asset, which it recovers through minimum lease payments (lease rents and guaranteed residual value) and the unguaranteed residual value. Viewed this way, the minimum lease payments and unguaranteed residual value (both from the standpoint of lessor) are loan instalments consisting of principals and finance charge (interest). The aggregate present value of minimum lease payments and present value of unguaranteed residual value should therefore be equal to the total principal, i.e. the fair value of the leased asset. The implied rate of interest, called the 'interest rate implicit on lease' is defined (See paragraph 3) as the discounting rate at which aggregate present value of minimum lease payments and present value of unguaranteed residual value, both from the standpoint of lessor, equals the fair value of leased asset.

Computation of interest rate implicit on lease

Discounting rate = R% p.a;

Lease Rents = L_1, L_2 ……… L_n (Payable annually, at the end of each year)

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

Fair Value at the inception (beginning) of lease = FV

PV of MLP $\frac{L_1}{(1+R)^1}+\frac{L_2}{(1+R)^2}+\frac{L_n}{(1+R)^n}+\frac{GR}{(1+R)^n}$

Present value of unguaranteed residual value = $\frac{UGR}{(1+R)^n}$

If interest rate implicit on lease is used as discounting rate:

Fair Value = PV of Minimum Lease Payments + PV of unguaranteed residual value ….. (1)

The interest rate implicit on lease can be computed by trial and error, provided the information required, e.g. the unguaranteed residual value can be reasonably ascertained.

Example 1

Annual lease rents	=	Rs 50,000 at the end of each year.
Lease period	=	5 years;
Guaranteed residual value	=	Rs. 25,000
Unguaranteed residual value	=	Rs. 15,000
Fair Value at the inception (beginning) of lease	=	Rs. 2,00,000

Interest rate implicit on lease is computed below:

Interest rate implicit on lease is a discounting rate at which present value of minimum lease payments and unguaranteed residual value is Rs. 2 lakh

PV of minimum lease payments and unguaranteed residual value at guessed rate 10%

Year	**Lease Payments**	**DF (10%)**	**PV**
	Rs.		Rs.
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550

4	50.000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
5	15,000	0.621	9,315
			2,14,340

PV of minimum lease payments and unguaranteed residual value at guessed rate 14%

Year	Lease Payments Rs.	DF (14%)	PV Rs.
1	50,000	0.877	43,850
2	50,000	0.769	38,450
3	50,000	0.675	33,750
4	50.000	0.592	29,600
5	50,000	0.519	25,950
5	25,000	0.519	12,975
5	15,000	0.519	7,785
			1,92,360

Interest rate implicit on lease is computed below by interpolation:

Interest rate implicit on lease = 40% + $\frac{14\% - 10\%}{2,14,340 - 1,92,360} \times (2,14,340 - 2,00,000) = 12.6\%$

Recognition of asset and liability

At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability at lower of (i) present value of minimum lease payments and (ii) fair value of leased asset. The discounting rate should be interest rate implicit on lease. Where interest rate implicit on lease is not determinable, the lessee's incremental borrowing rate should be used as discounting rate. (As distinguished from rate of interest on lessee's existing loans, the incremental borrowing rate is the rate of interest at which the lessee can borrow fresh funds under terms, similar to lease arrangement.)

Where interest rate implicit on lease is determinable, the present value of minimum lease payments is determined using the interest rate implicit on lease as discounting rate. From (1) above, in such cases: PV of minimum lease payment < Fair Value. Hence, where interest rate implicit on lease is determinable, the asset and liability is recognised at PV of minimum lease payments.

Example 2

Present value of minimum lease payment using data for example 1 is computed below:

Year	MLP Rs.	DF (12.6%)	PV Rs.
1	50,000	0.890	44,500
2	50,000	0.790	39,500
3	50,000	0.700	35,000
4	50.000	0.622	31,100
5	50,000	0.552	27,600
5	25,000	0.552	13,800
			1,91,500

Present value of minimum lease payment = Rs. 1,91,500

Fair value of leased asset = Rs. 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	Rs.	Rs.
Asset	1,91,500	
To Lessor		1,91,500
(Being recognition of finance lease as asset and liability)		

Recognition of Finance Charge (Paragraph 16)

Minimum lease payments consist of finance charges and the principals. The principal components reduce the liability to the lessor. The finance charge components are recognised as expenses in the periods the lease payments are incurred. In analyzing the lease payments, a constant periodic rate of interest is used. Where the liability is recognised at present value of minimum lease payments, e.g. where interest rate implicit on lease is determinable, the rate of interest to be used for analysis of lease rents is the discounting rate. Where the liability is recognised at fair value, the rate of interest must be determined by trial and error as the discounting rate at which present value of minimum lease payments equals the fair value.

Example 3

Using data for example 1, allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments	Finance Charge (12.6%)	Principal	Principal due
	Rs.	Rs.	Rs.	Rs.
0	--	--	--	1,91,500
1	50,000	24,129	25,871	1,65,629
2	50,000	20,869	29,131	1,36,498
3	50,000	17,199	32,801	1,03,697
4	50,000	13,066	36,934	66,763
5	75,000	8,237	66,763	
	2,75,000	83,500	1,91,500	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

	Rs.	Rs.
Finance Charge	24,129	
To Lessor		24,129
(Being finance charge due for the year)		
Lessor	50,000	
To Bank		50,000
(Being payment of lease rent for the year)		
P & L A/c	24,129	
To Finance Charge		24,129
(Being recognition of finance charge as expense for the year)		

Example 4

In example 1, suppose unguaranteed residual value is not determinable and lessee's incremental borrowing rate is 10%.

Since interest rate implicit on lease is discounting rate at which present value of minimum lease payment and present value of unguaranteed residual value equals the fair value, interest rate implicit on lease cannot be determined unless unguaranteed residual value is known. If interest rate implicit on lease is not determinable, the present value of minimum lease payments should be determined using lessee's incremental borrowing rate.

Present value of minimum lease payment using lessee's incremental borrowing rate 10% is computed below:

Year	MLP Rs.	DF (10%)	PV Rs.
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50.000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
			2,05,025

Present value of minimum lease payment = Rs. 2,05,025

Fair value of leased asset = Rs. 2,00,000

The accounting entry at the inception of lease to record the asset taken on finance lease in books of lessee is suggested below:

	Rs.	Rs.
Asset	2,00,000	
To Lessor		2,00,000
(Being recognition of finance lease as asset and liability)		

Since the liability is recognised at fair value Rs. 2 lakh (total principal), we need to ascertain a discounting rate at which present value minimum lease payments equals Rs. 2 lakh. The discounting rate can then be used for allocation of finance charge over lease period.

PV of minimum lease payments at guessed rate 12%

Year	Minimum Lease Payments	DF (12%)	PV
	Rs.		Rs.
1	50,000	0.893	44,650
2	50,000	0.797	39,850
3	50,000	0.712	35,600
4	50.000	0.636	31,800
5	50,000	0.567	28,350
5	25,000	0.567	14,175
			1,94,425

Required discounting rate = $10\% + \dfrac{12\% - 10\%}{2{,}05{,}025 - 1{,}94{,}425} \times (2{,}05{,}025 - 2{,}00{,}000) = 10.95\%$

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments	Finance Charge (10.95%)	Principal	Principal due
	Rs.	Rs.	Rs.	Rs.
0	--	--	--	2,00,000
1	50,000	21,900	28,100	1,71,900
2	50,000	18,823	31,177	1,40,723
3	50,000	15,409	34,591	1,06,132
4	50,000	11,621	38,379	67,753
5	75,000	7,247	67,753	
	2,75,000	75,000	2,00,000	

Accounting entries in year 1 to recognise the finance charge in books of lessee are suggested below:

	Rs.	Rs.
Finance Charge	21,900	
To Lessor		21,900
(Being finance charge due for the year)		
Lessor	50,000	
To Bank		50,000
(Being payment of lease rent for the year)		
P & L A/c	21,900	
To Finance Charge		21,900
(Being recognition of finance charge as expense for the year)		

Depreciation

The depreciation policy for a leased asset should be consistent with that for depreciable assets, which are owned, and the depreciation recognised should be calculated in accordance with Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

Contingent Rents and other costs

Contingent rents, costs for services and taxes are recognised as expense as and when incurred.

Disclosures (Paragraph 22)

The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;

(b) for each class of assets, the net carrying amount at the balance sheet date;

(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:

- (i) not later than one year;
- (ii) later than one year and not later than five years;
- (iii) later than five years;

(d) contingent rents recognised as expense in the statement of profit and loss for the period;

(e) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date; and

(f) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

   (i) the basis on which contingent rent payments are determined;

   (ii) the existence and terms of renewal or purchase options and escalation clauses; and

   (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III enterprises need not make disclosures required by paragraphs 22(c), (e) and (f).

Accounting for finance leases (Books of lessor)

In a finance lease, the lessee effectively buys the leased asset sold by the lessor. The lessor recognises the net investment in lease (which is usually equal to fair value, i.e. usual market price of the asset, as shown below) as receivable by debiting the Lessee A/c. Where the lessor pays to purchase the asset for giving on finance lease, the corresponding account credited is Bank. Where the lessor is a manufacturer or dealer, the corresponding account credited is Sales. In the later case, the difference between the sale value recognised and cost of the asset gets recognised as profit / loss on transfer to the statement of profit and loss of the period of inception of lease. (See paragraphs 26 and 32)

If discounting rate is interest rate implicit on lease, an analysis of definitions given in paragraph 3 shows that the Net Investment in Lease is fair value of leased asset.

Gross investment in Lease (GIL)

= Minimum Lease Payments (MLP) + Unguaranteed Residual value (UGR)

Net investment in Lease (NIL)

= Gross investment in Lease (GIL) – Unearned Finance Income (UFI).

Unearned finance income (UFI) = GIL – (PV of MLP + PV of UGR)

The discounting rate for the above purpose is the <u>rate of interest implicit in the lease</u>.

From the definition of interest rate implicit on lease:

(PV of MLP + PV of UGR) = Fair Value.

The above definitions imply that:

(a) Unearned Finance Income (UFI) = GIL – Fair Value

(b) Net Investment in Lease = GIL – UFI = GIL – (GIL – Fair Value) = Fair Value

Since the sale and receivables are recognised at net investment in lease, which is equal to fair value: Profit recognised at the inception of lease = Fair Value – Cost

Total earning of lessor = GIL – Cost

= (GIL – Fair Value) + (Fair Value – Cost)

= Unearned Finance Income + (Fair Value – Cost)

The above analysis does not hold where the discounting rate is not equal to interest rate implicit on lease. Such is the case, where the interest rate implicit on lease is artificially low. As per paragraph 32, the discounting rate in such situations should be the commercial rate of interest.

Recognition of Finance Income

The unearned finance income is recognised over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment in lease outstanding.

The constant periodic return is the rate used for discounting, i.e. either the interest rate implicit on lease or the commercial rate of interest.

Contingent Rents and Initial Direct Costs

Contingent rents, fees for services and taxes recovered from lessee are recognised as income as and when they accrue. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

Review of unguaranteed residual value by lessor

Paragraph 30 requires a lessor to review unguaranteed residual value used in computing the gross investment in lease regularly. In case any reduction in the estimated unguaranteed residual value is identified, the income allocation over the remaining lease term is to be revised. Also, any reduction in respect of income already accrued is to be recognised immediately. An upward adjustment of the estimated residual value is not made.

Interest rate implicit on lease is a discount rate at which sum of present value of minimum lease payments and present value of unguaranteed residual value (both from the standpoint of lessor) is equal to fair value. A revision of unguaranteed residual value affects the interest rate implicit on lease having consequential effect on allocation of finance income. Where a commercial rate is used for discounting, a revision of unguaranteed residual value affects net investment on lease, having consequential effect on income allocation, including profit recognised at the inception of lease.

Disclosures

The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

  (i) not later than one year;

  (ii) later than one year and not later than five years;

  (iii) later than five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;

(d) the accumulated provision for uncollectible minimum lease payments receivable;

(e) contingent rents recognised in the statement of profit and loss for the period;

(f) a general description of the significant leasing arrangements of the lessor; and

(g) accounting policy adopted in respect of initial direct costs.

(h) As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases. (Paragraph 38)

Note: The Level II and Level III enterprises need not make disclosures required by paragraphs 37(a), (f) and (g).

Accounting for Operating Leases

Operating leases are non-payout leases, i.e. an individual contract of operating lease does not usually recover the entire cost of leased asset for the lessor. A lessor gives same asset repeatedly under operating leases to recover its cost and to earn a profit margin. This being so, unlike finance leases, lease rents under operating leases cannot be regarded as to consist of principals and finance charges. These are treated as expenses in the books of the lessee and income in the books of the lessor.

Books of lessee

Lease payments are frequently tailor made to suit the payment capacity of the lessee. For example, a lease term may provide for low initial rents and high terminal rent. Such payment patterns do not reflect the pattern of benefit derived by the lessee from the use of leased asset. To have better matching between revenue and costs, paragraph 23 of the standard requires lessees to recognise operating lease payments as expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1, 20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are Rs. 25,000, Rs. 45,000 and Rs. 50,000 respectively. The total lease payment Rs. 1, 20,000 in this example should be recognised in proportion of output as Rs. 15,000 in year 1, Rs. 30,000 in year 2 and Rs. 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Rent Adjustment A/c.

The accounting entries for year 1 in books of lessee are suggested below:

	Rs.	Rs.
Lease Rent	25,000	
To Lessor		25,000
(Being lease rent for the year due)		
Lessor	25,000	
To Bank		25,000
(Being payment of lease rent for the year)		
Lease Rent Adjustment	15,000	
P & L A/c	10,000	
To Lease Rent		25,000
(Being recognition of lease rent as expense for the year)		

Since total lease rent due and recognised must be same, the Lease Rent Adjustment A/c will close in the terminal year. Till then, the balance of Lease Rent Adjustment A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Disclosures by lessees

The paragraph 25 requires lessees to make following disclosures for operating leases:

(a) the total of future minimum lease payments under non-cancelable operating leases for each of the following periods:

- (i) not later than one year;
- (ii) later than one year and not later than five years;
- (iii) later than five years;

(b) the total of future minimum sublease payments expected to be received under non-cancelable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

  (i) the basis on which contingent rent payments are determined;

  (ii) the existence and terms of renewal or purchase options and escalation clauses; and

  (iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

Note: The Level II and Level III enterprises need not make disclosures required by paragraphs 25(a), (b) and (e).

Books of lessor

Paragraph 39 requires a lessor to treat assets given under operating leases as fixed assets in its balance sheets and paragraph 41 requires depreciation to be recognized in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6. (Paragraph 43)

The impairment losses on assets given on operating leases are determined and treated as per AS 28. (Paragraph 44)

A manufacturer or dealer lessor should bring the asset given on operating lease as fixed asset in their books by debiting concerned Fixed Asset A/c and crediting Cost of Production / Purchase at cost. No selling profit should be recognised on entering into operating lease, because such leases are not equivalents of sales (Paragraph 45)

Lease income from operating leases should be recognised in the statement of profit and loss on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished. (Paragraph 40)

Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred. (Paragraph 42)

Suppose outputs from a machine of economic life of 6 years are estimated as 10,000 units in year 1, 20,000 units in year 2 and 30,000 units in year 3, 40,000 units in year 4, 20,000 units in year 5 and 5,000 units in year 6. The machine was given on 3-year operating lease by a dealer of the machine for equal annual lease rentals to yield 20% profit margin on cost Rs. 5,00,000. Straight-line depreciation in proportion of output is considered appropriate.

$$\text{Total lease rent} = 120\% \text{ of Rs. 5 lakh} \times \frac{\text{Output during lease period}}{\text{Total output}} -$$

$$= \text{Rs. 6 lakh} \times \frac{60{,}000 \text{ units}}{125{,}000 \text{ units}} = \text{Rs. 2. 88 lakh}$$

Annual lease rent = Rs. 2,88,000 / 3 = Rs. 96,000

Total lease rent should be recognised as income in proportion of output during lease period, i.e. in the proportion of 10 : 20 : 30. Hence income recognised in years 1, 2 and 3 are Rs. 48,000, Rs. 96,000 and Rs. 1,44,000 respectively.

Since depreciation in proportion of output is considered appropriate, the depreciable amount Rs. 5 lakh should be allocated over useful life 6 years in proportion of output, i.e. in proportion of 10 : 20 : 30 : 40 : 20 : 5. Depreciation for year 1 is Rs. 40,000.

The accounting entries for year 1 in books of lessor are suggested below:

	Rs.	Rs.
Machine given on Operating Lease	5,00,000	
To Purchase		5,00,000
(Being machine given on operating lease brought into books)		
Lessee	96,000	
To Lease Rent		96,000
(Being lease rent for the year due)		
Bank	96,000	
To Lessee		96,000
(Being receipt of lease rent for the year)		
Lease Rent	96,000	
To P & L A/c		48,000
To Lease Rent Adjustment		48,000
(Being recognition of lease rent as income for the year)		

Depreciation	40,000	
To Machine given on Operating Lease		40,000
(Being depreciation for the year)		
P & L A/c	40,000	
To Depreciation		40,000
(Being depreciation for the year transferred to P & L A/c)		

Since total lease rent due and recognised must be same, the Lease Rent Adjustment A/c will close in the terminal year. Till then, the balance of Lease Rent Adjustment A/c can be shown in the balance sheet under "Current Assets" or Current Liabilities" depending on the nature of balance.

Disclosures by lessors

As per paragraph 46, the lessor should, in addition to the requirements of AS 6, AS 10, and the governing statute, make the following disclosures for operating leases:

(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and

(i) the depreciation recognised in the statement of profit and loss for the period;

(ii) impairment losses recognised in the statement of profit and loss for the period;

(iii) impairment losses reversed in the statement of profit and loss for the period;

(b the future minimum lease payments under non-cancelable operating leases in the aggregate and for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(c) total contingent rents recognised as income in the statement of profit and loss for the period;

(d) a general description of the lessor's significant leasing arrangements; and

(e) accounting policy adopted in respect of initial direct costs.

Note: The Level II and Level III enterprises need not make disclosures required by paragraphs 46(b), (d) and (e).

Sale and Leaseback

The basis of a sale and leaseback agreement is simply that one sells an asset for cash and then leases it back from the buyer. The asset subject to such sale and leaseback agreement is generally property. Under such an agreement the property owner agrees to sell the property at an agreed valuation and lease it back from the buyer. The lessee or seller receives cash immediately and makes periodic payment in form of lease rents for right to use the property. The lease payments and the sale price are generally interdependent as they are negotiated as a package. The accounting treatment of a sale and lease back depends upon the type of lease involved. Accounting treatment of profits / losses on sale of asset, as required by the standard in respect of sale and lease-back transactions, are summarised below.

Where sale and leaseback results in finance lease

The excess or deficiency of sales proceeds over the carrying amount should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Where sale and leaseback results in operating lease

If the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately. (Paragraph 52)

After recognition of loss if any, under paragraph 52, the profit / loss on sale of the asset should be treated in the manner required by paragraph 50. The requirements of paragraph 50 are summarized below:

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

Profit should be recognised immediately. The loss should also be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used.

Case 3: Sale Price > Fair Value

The excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

2.7 ACCOUNTING STANDARD 20: EARNINGS PER SHARE

This AS comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature.

This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

An *equity share* is a share other than a preference share.

A *preference share* is a share carrying preferential rights to dividends and repayment of capital.

A *financial instrument* is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

For this purpose, a *financial asset* is any asset that is

a. Cash;

b. A contractual right to receive cash or another financial asset from another enterprise;

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

d. An equity share of another enterprise.

A *financial liability* is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

A *potential equity share* is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

Examples of potential equity shares are:

a. Debt instruments or preference shares, that are convertible into equity shares;

b. Share warrants;

c. Options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

d. Shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

Share warrants or options are financial instruments that give the holder the right to acquire equity shares.

An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

This Statement requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

Basic Earnings Per Share

Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless AS – 5 requires or permits otherwise. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

The amount of preference dividends for the period that is deducted from the net profit for the period is:

a. The amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

b. The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

The weighted average number of equity shares is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration:

Date	Particulars	Purchased	Sold	Balance
1st January	Balance at beginning of year	1,800	-	1,800
31st May	Issue of shares for cash	600	-	2,400
1st November	Buy Back of shares	-	300	2,100

Calculate Weighted Number of Shares.

Solution:

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable, for example:

a. Equity shares issued in exchange for cash are included when cash is receivable;

b. Equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

c. Equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

d. Equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

e. Equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

f. Equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition and in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period.

Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares is calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

a. A bonus issue;

b. A bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

c. A share split; and

d. A reverse share split (consolidation of shares).

Illustration:

Date	Particulars	No. of Share	Face Value	Paid up Value
1st January	Balance at beginning of year	1,800	Rs. 10	Rs. 10
31st October	Issue of Shares	600	Rs. 10	Rs. 5

Calculate Weighted Number of Shares.

Solution:

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

$$(1,800 \times 12/12) + (300 \times 2/12) = 1,850 \text{ shares.}$$

In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources.

The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported.

Illustration:

Net profit for the year 2007	Rs. 18,00,000
Net profit for the year 2008	Rs. 60,00,000
No. of equity shares outstanding until 30th September 2008	20,00,000

Bonus issue 1st October 2008 was 2 equity shares for each equity share outstanding at 30th September, 2008

Calculate Basic Earnings Per Share.

Solution:

No. of Bonus Issue 20,00,000 × 2 = 40,00,000 shares

Earnings per share for the year 2008 $\dfrac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$

= Re. 1.00

Adjusted earnings per share for the year 2007 $\dfrac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$

= Re. 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2007, the earliest period reported.

In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following adjustment factor:

Fair value per share immediately prior to the exercise of rights

Theoretical ex-rights fair value per share

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights.

Illustration:

Net profit for the year 2007	Rs. 11,00,000
Net profit for the year 2008	Rs. 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares
Rights issue price	Rs. 15.00
Last date to exercise rights	1st March 2008

Rights issue is one new share for each five outstanding (i.e. 1,00,000 new shares)

Fair value of one equity share immediately prior to exercise of rights on 1st March 2008 was Rs. 21.00. Compute Basic Earnings Per Share.

Solution:

$$\frac{\text{Fair value of shares immediately prior to exercise of rights + Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + number of shares issued in the exercise}}$$

$$\frac{(\text{Rs. } 21.00 \times 5{,}00{,}000 \text{ shares}) + (\text{Rs. } 15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = Rs. 20.00

Computation of adjustment factor:

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}}$$

$$\frac{\text{Rs. } (21.00)}{\text{Rs. } (20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2007 as originally reported: Rs. 11,00,000/5,00,000 shares = Rs. 2.20

EPS for the year 2007 restated for rights issue: Rs. 11,00,000/ (5,00,000 shares x 1.05)

= Rs. 2.10

EPS for the year 2008 including effects of rights issue:

(5,00,000 x 1.05 x 2/12) + (6,00,000 x 10/12) = 5,87,500 shares

EPS = 15,00,000/5,87,500 = Rs. 2.55

Diluted Earnings Per Share

In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:

   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

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

For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet date, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in Basic Earnings Per Share is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

a. A contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

b. A contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

In order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration:

Net profit for the current year	Rs. 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	Rs. 2.00
No. of 12% convertible debentures of Rs. 100 each	1,00,000

Each debenture is convertible into 10 equity shares

Interest expense for the current year	Rs. 12,00,000
Tax relating to interest expense (30%)	Rs. 3,60,000

Compute Diluted Earnings Per Share.

Solution:

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000)

= Rs. 1,08,40,000

No. of equity shares resulting from conversion of debentures: 10,00,000 Shares

No. of equity shares used to compute diluted EPS: (50,00,000 + 10,00,000) = 60,00,000 Shares

Diluted earnings per share: (1,08,40,000/60,00,000) = Rs. 1.81

Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

Disclosure

An enterprise should disclose the following:

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

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

c. The nominal value of shares along with the earnings per share figures.

If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

Illustration:

Net profit for the year 2008	Rs. 12,00,000
Weighted average number of equity shares outstanding during the year 2008	5,00,000 shares
Average fair value of one equity share during the year 2008	Rs. 20.00
Weighted average number of shares under option during the year 2008	1,00,000 shares
Exercise price for shares under option during the year 2008	Rs. 15.00

Compute Basic and Diluted Earnings Per Share.

Solution:

Computation of earnings per share

	Earnings	**Shares**	**Earnings/ Share**
	Rs.		Rs.
Net profit for the year 2008	12,00,000		
Weighted average no. of shares during year 2008		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

2.8 INTANGIBLE ASSETS (AS 26)

AS 26, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

i. Enterprises whose equity or debt securities are listed on a recognized stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognized stock exchange in India as evidenced by the board of directors' resolution in this regard.

ii. All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs. 50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

From the date of this Standard becoming mandatory for the concerned enterprises, AS 8; AS 6 & AS 10 stand withdrawn for the aspects relating to Intangible Assets.

Scope

This Statement should be applied by all enterprises in accounting for intangible assets, except:

a. Intangible assets that are covered by another Accounting Standard like AS 2; 7; 14; 19; 21 & 22.

b. Financial assets.

c. Mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources and

d. Intangible assets arising in insurance enterprises from contracts with policyholders.

Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.

This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

An *asset* is a resource:

a. Controlled by an enterprise as a result of past events and

b. From which future economic benefits are expected to flow to the enterprise.

Monetary assets are money held and assets to be received in fixed or determinable amounts of money.

Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

An *active market* is a market where all the following conditions exist:

a. The items traded within the market are homogeneous.

b. Willing buyers and sellers can normally be found at any time and

c. Prices are available to the public.

An *impairment loss* is the amount by which the carrying amount of an asset exceeds its recoverable amount.

A *financial asset* is any asset that is:

a. Cash,

b. A contractual right to receive cash or another financial asset from another enterprise,

c. A contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable or

d. An ownership interest in another enterprise.

Intangible Assets

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

Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks.

Not all the items described above will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.

In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. Judgement is required to assess as to which element is predominant. If use of physical assets is possible only with the intangible part of it, we treat them as Fixed Assets like Operating system for computers. If physical element is just to support intangible part of it, we treat them as intangible assets.

Identifiability

The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity. Though Separability is not a necessary condition for identifiability. If an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement or by a legal duty on employees to maintain confidentiality.

Future economic benefit is also flown from the skill of labour and customer loyalty but usually this flow of benefits cannot be controlled by the enterprise. As employees may quite the concern anytime or even loyal customers may decide to purchase goods and services from other suppliers. Moreover these items don't even qualify as intangible asset as per the definition given in this AS.

Future Economic Benefits

The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise.

Recognition and Initial Measurement of an Intangible Asset

The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the definition of an intangible asset and recognition criteria set out as below:

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence and

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

An intangible asset should be measured initially at cost.

Separate Acquisition

If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

Acquisition as Part of an Amalgamation

An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with AS 14. In accordance with this Statement:

a. A transferee recognises an intangible asset that meets the recognition criteria, even if that intangible asset had not been recognised in the financial statements of the transferor and

b. If the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill.

Hence, judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. The cost initially recognised for the intangible asset in this case is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

Acquisition by way of a Government Grant

In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. AS 12, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

Internally Generated Intangible Assets

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into Research Phase & Development Phase. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

No intangible asset arising from research or from the research phase should be recognised. Expenditure on research or on the research phase should be recognised as an expense when it is incurred.

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

b. The search for, evaluation and final selection of, applications of research findings or other knowledge.

c. The search for alternatives for materials, devices, products, processes, systems or services;

d. The formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

An intangible asset arising from development or from the development phase should be recognised if, and only if, an enterprise can demonstrate all of the following:

a. The technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. Its intention to complete the intangible asset and use or sell it.

c. Its ability to use or sell the intangible asset.

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

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

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

Examples of development activities are:

a. The design, construction and testing of pre-production or pre-use prototypes and models.

b. The design of tools, jigs, moulds and dies involving new technology.

c. The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production and

d. The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

An enterprise assesses the future economic benefits to be received from the asset using the principles in Accounting Standard on Impairment of Assets.

An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

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

Cost of an Internally Generated Intangible Asset

The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use from the time when the intangible asset first meets the recognition criteria. The cost includes, if applicable:

a Expenditure on materials and services used or consumed in generating the intangible asset.

b. The salaries, wages and other employment related costs of personnel directly engaged in generating the asset.

c. Any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset and

d. Overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset. Allocations of overheads are made on bases similar to those discussed in AS 2 & AS 16.

The following are not components of the cost of an internally generated intangible asset:

a. Selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use.

b. Clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance and

c. Expenditure on training the staff to operate the asset.

Recognition of an Expense

Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

a. It forms part of the cost of an intangible asset that meets the recognition criteria or

b. The item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. It forms part of the amount attributed to goodwill (capital reserve) at the date of acquisition.

It does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Expenses recognized as expenses cannot be reclassified as cost of Intangible Asset in later years.

Subsequent Expenditure

Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

a. It is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance and

b. The expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

Subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance is always recognised as an expense to avoid the recognition of internally generated goodwill.

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

Amortisation Period

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

Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

a. Amortises the intangible asset over the best estimate of its useful life.

b. Estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss and

c. Discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset.

If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless the legal rights are renewable and renewal is virtually certain.There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

Amortisation Method

A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

Residual Value

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

a. There is a commitment by a third party to purchase the asset at the end of its useful life or

b. There is an active market for the asset and:

   i. Residual value can be determined by reference to that market and

   ii. It is probable that such a market will exist at the end of the asset's useful life.

Review of Amortisation Period and Amortisation Method

During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. Therefore, the amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5.

Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 "Impairment of Assets" is not covered under PCC curriculum and will be discussed in the later stages of CA Course..

If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under AS 28 and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

In addition to the requirements of AS 28, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

a. An intangible asset that is not yet available for use and

b. An intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.

The recoverable amount should be determined under AS 28 and impairment losses recognised accordingly.

If the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the required impairment test and makes the disclosure required.

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

Disclosure

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

a. The useful lives or the amortisation rates used.

b. The amortisation methods used.

C. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.

D. A reconciliation of the carrying amount at the beginning and end of the period showing:

  I. Additions, indicating separately those from internal development and through amalgamation.

  II. Retirements and disposals.

  III. Impairment losses recognised in the statement of profit and loss during the period.

  IV Impairment losses reversed in the statement of profit and loss during the period.

  V Amortisation recognised during the period and

  VI Other changes in the carrying amount during the period.

Other Disclosures

The financial statements should also disclose:

a.. If an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset.

b. A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole.

c. The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities and

d. The amount of commitments for the acquisition of intangible assets.

The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

Transitional Provisions

Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under this Statement and the period determined has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined has not expired on the date of this Statement coming into effect and:

a. If the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

b. If the remaining period as per the accounting policy followed by the enterprise:

    i. Is shorter as compared to the balance of the period determined, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

    ii. Is longer as compared to the balance of the period determined, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period.

2.9 ACCOUNTING STANDARD 29: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

i. Those resulting from financial instruments that are carried at fair value;

ii. Those resulting from executory contracts;

iii. Those arising in insurance enterprises from contracts with policy-holders; and

iv. Those covered by another Accounting Standard.

Where any other Accounting Standard like 7; 9; 15, 19 deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement.

Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

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 recognised because:

   (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

   (ii) A reliable estimate of the amount of the obligation cannot be made.

A *Contingent asset* is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not 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.

Recognition

Provisions

A provision should be recognised when:

(a) An enterprise has a present obligation as a result of a past event;

(b) It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) A reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

(a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

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.

Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions.

An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Reliable Estimate of the Obligation

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability.

Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

Measurement

Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

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

Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

Restructuring

The following are examples of events that may fall under the definition of restructuring:

(a) Sale or termination of a line of business;

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) Changes in management structure, for example, eliminating a layer of management; and

(d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

As required by paragraph 44 of the satndard, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

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, and

(c) The amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) An estimate of its financial effect,

(b) An indication of the uncertainties relating to any outflow; and

(c) The possibility of any reimbursement.

Miscellaneous Illustrations

Illustration 1

On 20.4.2005 JLC Ltd. obtained a loan from the Bank for Rs. 50 lakhs to be utilised as under:

	Rs.
Construction of a shed	20 lakhs
Purchase of machinery	15 lakhs
Working capital	10 lakhs
Advance for purchase of truck	5 lakhs

In March, 2006 construction of shed was completed and machinery installed. Delivery of truck was not received. Total interest charged by the bank for the year ending 31.3.2006was Rs. 9 lakhs. Show the treatment of interest under AS 16.

Solution

As per AS 16, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalized. A qualifying asset is an asset that necessarily takes a substantial period of time (usually 12 months or more) to get ready for its intended use or sale. If an asset is ready for its intended use or sale at the time of its acquisition then it is not treated as a qualifying asst for the purposes of AS 16.

Treatment of interest as per AS 16

	Particulars	**Nature**	**Interest to be capitalized**	**Interest to be charged to profit and loss account**
(1)	Construction of a shed	Qualifying asset	$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 20 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 3.60 lakhs	

(2)	Purchase of machinery	Not a qualifying asset[*]		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 15 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 2.70 lakhs.
(3)	Working capital	Not qualifying asset		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 10 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 1.80 lakhs
(4)	Advance for purchase of truck	Not a qualifying asset		$\left(\text{Rs. 9 lakhs} \times \frac{\text{Rs. 5 lakhs}}{\text{Rs. 50 lakhs}}\right)$ = Rs. 0.90 lakhs
	Total		Rs.3.60 lakhs	Rs.5.40 lakhs

Illustration 2

A limited company created a provision for bad and doubtful debts at 2.5% on debtors in preparing the financial statements for the year 2005-2006.

Subsequently on a review of the credit period allowed and financial capacity of the customers, the company decided to increase the provision to 8% on debtors as on 31.3.2006. The accounts were not approved by the Board of Directors till the date of decision. While applying the relevant accounting standard can this revision be considered as an extraordinary item or prior period item?

Solution

Preparation of financial statements involve making estimates which are based on the circumstances existing at the time when the financial statements are prepared. It may be necessary to revise an estimate in a subsequent period if there is a change in the circumstances on which the estimate was based. Revision of an estimate, by its nature, does not bring the adjustment within the definitions of a prior period item or an extraordinary item [para 21 of AS 5 (Revised) on Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies].

In the given case, a limited company created 2.5% provision for doubtful debts for the year 2003-2004. Subsequently in 2004 they revised the estimates based on the changed circumstances and wants to create 8% provision. As per AS-5 (Revised), this change in estimate is neither a prior period item nor an extraordinary item.

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[*] On the basis that machinery is ready for its intended use at the time of its acquisition/purchase.

However, as per para 27 of AS 5 (Revised), a change in accounting estimate which has material effect in the current period, should be disclosed and quantified. Any change in the accounting estimate which is expected to have a material effect in later periods should also be disclosed.

Illustration 3

How would you deal with the following in the annual accounts of a company for the year ended 31st march, 2008 ?

(a) The company has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' Godown. Up to 2006-07, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2006-07. This would result into decrease in profit by Rs. 7.60 lakhs

(b) Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of Rs. 5.30 lakhs for the period October, 2002 to September, 2006 has been received and paid in February, 2007.

Solution

(a) Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" states that a change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise. Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements. As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements.

Also, appropriate disclosure of the change and the amount by which any item in the financial statements is affected by such change is necessary as per AS 1, AS 2 and AS 5. Therefore, the under mentioned note should be given in the annual accounts.

"In compliance with the Accounting Standards issued by the ICAI, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by Rs. 7.60 lakhs."

(b) The final bill having been paid in February, 2007 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2007. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2007, this material charge has arisen in the current period i.e., year ended 31st March, 2008. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.'

Illustration 4

In preparing the financial statements of R Ltd. for the year ended 31st March, 2008, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2008 in the acquisition of another company doing similar business, the negotiations for which had started during the financial year.

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2008 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Para 3.2 of AS 4 (Revised) defines "Events occurring after the balance sheet date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2008. Applying para 15 which clearly states that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of Rs. 100 lakhs in April, 2008 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Illustration 5

A Limited Company closed its accounting year on 30.6.08 and the accounts for that period were considered and approved by the board of directors on 20th August, 2008. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2008 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of Rs. 80 lakhs. You are required to state with reasons, how the event would be dealt with in the financial statements for the year ended 30.6.08.

Solution

(a) Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Directors' Report.

Illustration 6

While preparing its final accounts for the year ended 31st March, 2008 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2008 a debtor for Rs. 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2008 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2008?

Solution

(b) As per paras 8.2 and 13 of Accounting Standard 4 on Contingencies and Events Occurring after the Balance Sheet Date, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to Rs. 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2008. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2008, then mere disclosure required as per para 15, would have been sufficient.

Illustration 7

At the end of the financial year ending on 31st December, 2007, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

	Probability	Loss (Rs.)
In respect of five cases (Win)	100%	–
Next ten cases (Win)	60%	–
Lose (Low damages)	30%	1,20,000
Lose (High damages)	10%	2,00,000
Remaining five cases		
Win	50%	–
Lose (Low damages)	30%	1,00,000
Lose (High damages)	20%	2,10,000

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

(a) According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognized as provision.

(ii) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of Rs. 1,20,000 + 10% of Rs. 2,00,000

= Rs. 36,000 + Rs. 20,000

= Rs. 56,000

Expected loss in remaining five cases = 30% of Rs. 1,00,000 + 20% of Rs. 2,10,000

= Rs. 30,000 + Rs. 42,000

= Rs. 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of Rs. 9,20,000 (Rs. 56,000 × 10 + Rs. 72,000 × 5) as contingent liability.

Illustration 8

X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2007 – 31.12.2007)

Net Profit	:	Year 2007 : Rs. 20,00,000
	:	Year 2008 : Rs. 30,00,000
No. of shares outstanding prior to Right Issue	:	10,00,000 shares
Right Issue	:	One new share for each four outstanding i.e., 2,50,000 shares.
		Right Issue price – Rs. 20
		Last date of exercise rights – 31.3.2008.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2008	:	Rs. 25

Solution

Computation of Basic Earnings Per Share

(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2007 Rs.	Year 2008 Rs.
EPS for the year 2007 as originally reported		
$= \dfrac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (Rs. 20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 2007 restated for rights issue		
= [Rs. 20,00,000 / (10,00,000 shares $\times$ 1.04*)]	1.92 (approx.)	
EPS for the year 2008 including effects of rights issue		
$\dfrac{\text{Rs. }30{,}00{,}000}{(10{,}00{,}000\text{ shares}\times 1.04\times 3/12)+(12{,}50{,}000\text{ shares}\times 9/12)}$		
$\dfrac{\text{Rs. }30{,}00{,}000}{11{,}97{,}500\text{ shares}}$		2.51 (approx.)

Working Notes:

1. Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights}+\text{Total amount received from exercise}}{\text{Number of shares outstanding prior to exercise}+\text{Number of shares issued in the exercise}}$$

$$=\frac{(\text{Rs. }25\times 10{,}00{,}000\text{ shares})+(\text{Rs. }20\times 2{,}50{,}000\text{ shares})}{10{,}00{,}000\text{ shares}+2{,}50{,}000\text{ shares}}$$

$$=\frac{\text{Rs. }3{,}00{,}00{,}000}{12{,}50{,}000\text{ shares}}=\text{Rs. }24$$

* Refer working note 2.

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$

$$= \frac{\text{Rs. 25}}{\text{Rs. 24 (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

Self-Examination Questions

I. Objective type Questions

Choose the most appropriate answer from the given options:

1. Capitalisation of borrowing costs should cease when
   (a) The borrowing is repaid in full.
   (a) The asset is fully complete.
   (b) Substantially all activities for putting the asset to use have been completed.
   (c) The asset is capitalized in the books.
2. Internally generated goodwill is
   (a) Recorded at cost of generating goodwill.
   (b) Recorded at valuation done by experts.
   (c) (a) or (b) whichever is less.
   (d) Not recorded.
3. To encourage industrial promotion, IDCI offers subsidy worth Rs. 50 lakhs to all new industries set up in the specified industrial areas. This grant is in the nature of promoter's contribution. How should such subsidy be accounted in the books of those industries.
   (a) Credit it to capital reserve.
   (b) Credit it as 'other income' in the profit and loss account in the year of commencement of commercial operations.
   (c) Both 1 and 2 are permitted.
   (d) Defer it over a period not exceeding 10 years.

4. A change in the estimated life of the asset, which necessitates adjustment in the depreciation is an example of

   (a) Prior period item.

   (b) Ordinary item.

   (c) Extraordinary item.

   (d) Change in accounting estimate.

5. On 1.1.2004, Rock Ltd. paid Rs. 25 per share for all 60,000 shares of Chair Ltd. The carrying amounts of Chair's identifiable assets and liabilities on 1.1.2004 are

	Rs.
Cash	1,20,000
Inventories	3,60,000 (market value Rs. 2,85,000)
Plant assets (net)	7,20,000 (valued at Rs. 8,40,000)

   The amount recognized as goodwill as a result of business combination is

   (a) Nil.

   (b) Rs. 75,000.

   (c) Rs. 2,55,000.

   (d) Rs. 2,70,000.

   [**Ans.** 1. (c), 2. (d), 3. (a), 4.(d), , 5. (c)]

II. Short Answer Questions

6 What are the disclosure requirements pertaining to events occurring after the balance sheet date?

7. When can an item qualify to be a prior period item?

8. Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.

9. The difference between actual expense or income and the estimated expense or income as accounted for in earlier years' accounts, does not necessarily constitute the item to be a perior period item comment.

10. When Capitalisation of borrowing cost should cease as per Accounting Standard 16?

11. Write short note on Sale and Lease Back Transactions as per Accounting Standard 19.

12. Decide when research and development cost of a project can be deferred to future periods as per AS 26.

13. How is software acquired for internal use accounted for under AS-26?

III. Long Answer Questions

14. Explain the provisions of AS 5 regarding treatment of prior period items and extra-ordiary items.

15. State the different types of Leases contemplated in Accounting Standard 19 and discuss briefly.

16. How will you calculate "Diluted Earnings per Share" as per Accounting Standard 20? Explain in detail.

17. Explain recognition principles for contingent liabilities according to AS 29

IV. Practical Problems

18. Advise P Co. Ltd. about the treatment of the following in the Final Statement of Accounts for the year ended 31st March, 2006.

    A claim lodged with the Railways in March, 2003 for loss of goods of Rs. 2,00,000 had been passed for payment in March, 2000 for Rs. 1,50,000. No entry was passed in the books of the Company, when the claim was lodged.

19. A company obtained term loan during the year ended 31st March, 2006 in an extent of Rs. 650 lakhs for modernisation and development of its factory. Buildings worth Rs. 120 lakhs were completed and Plant and Machinery worth Rs. 350 lakhs were installed by 31st March, 2006. A sum of Rs. 70 lakhs has been advanced for Assets the installation of which is expected in the following year. Rs. 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loan of Rs. 650 lakhs during the year 2005 – 2006amounted to Rs. 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?

20. While preparing its final accounts for the year ended 31st March, 2007 Rainbow Limited created a provision for Bad and Doubtful debts are 2% on trade debtors. A few weeks later the company found that payments from some of the major debtors were not forthcoming. Consequently the company decided to increase the provision by 10% on the debtors as on 31st March, 2007 as the accounts were still open awaiting approval of the Board of Directors. Is this to be considered as an extra-ordinary item or prior period item ?

21. A major fire has damaged the assets in a factory of a limited company on 2nd April-two days after the year end closure of account. The loss is estimated at Rs. 20 crores out of which Rs. 12 crores will be recoverable from the insurers. Explain briefly how the loss should be treated in the final accounts for the previous year.

22. There is a sales tax demand of Rs. 2.50 crores against a company relating to prior years against which the company has gone on appeal to the appellate authority in the department. The grounds of appeal deal with points covering Rs. 2 crores of the demand. State how the matter will have to be dealt with in the final accounts for the year.

23. You are an accountant preparing accounts of A Ltd. as on 31.3.2006. After year end the following events have taken place in April, 2006:

    (i) A fire broke out in the premises damaging, uninsured stock worth Rs. 10 lakhs (Salvage value Rs. 2 lakhs).

    (ii) A suit against the company's advertisement was filed by a party claiming damage of Rs. 20 lakhs.

    (iii) Dividend proposed @ 20% on share capital of Rs. 100 lakhs.

    (iv) Describe, how above will be dealt with in the account of the company for the year ended on 31.3.2006.

CHAPTER 3

ADVANCED ISSUES IN PARTNERSHIP ACCOUNTS

UNIT - 1 : DISSOLUTION OF PARTNERHIP FIRMS

Learning Objectives

After studying this unit, you will be able to:

- Go through the circumstances in which a partnership is dissolved.
- Understand that on dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to disposal of assets and payment of liabilities.
- Learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of deficit.

1.1 INTRODUCTION

Apart from readjustment of rights of partners in the share of profit by way of change in the profit sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we shall discuss the circumstances leading to dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also we shall discuss the special problems relating to insolvency of partners and settlement of partnership's liabilities.

1.2 CIRCUMSTANCES LEADING TO DISSOLUTION OF PARTNERSHIP

A partnership is dissolved or comes to an end on:

(a) the expiry of the term for which it was formed or the completion of the venture for which it was entered into;

(b) death of a partner;

(c) insolvency of a partner;

(d) retirement of a partner;

However, the partners or remaining partners (in case of death, insolvency or retirement) may continue to do the business. In such case there will be a new partnership but the firm will continue. When the business also comes to an end then only it will be said that the firm has been dissolved.

A firm stand dissolved in the following cases:

(i) the partners agree that the firm should be dissolved;

(ii) all partners except one become insolvent;

(iii) the business becomes illegal;

(iv) in case of partnership at will, a partner gives notice of dissolution; and

(v) the court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :

(a) where a partner has become of unsound mind;

(b) where a partner suffers from permanent incapacity;

(c) where a partner is guilty of misconducting the business;

(d) where a partner persistently disregards the partnership agreement;

(e) where a partner transfers his interest or share to a third party;

(f) where the business cannot be carried on except at a loss; and

(g) where it appears to be just and equitable.

1.3 CONSEQUENCES OF DISSOLUTION

On the dissolution of a partnership, the assets of the firm, including goodwill, are realised and the amount is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards the capital contributed by partners is repaid and, if there is still surplus, it is distributed among the partners in their profit-sharing ratio. Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm left over are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio. According to the provisions contained in Section 48 of the Partnership Act, upon a dissolution of partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

(a) Losses including deficiencies of capital are paid, first out of profits, next out of capital and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order :

(i) in paying the debts of the firm to third parties;

(ii) in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;

(iii) in paying to each partner what is due to him on account of capital; and

(iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

The death or retirement of a partner would not result in the dissolution of the partnership, if the partnership agreement so provides (Section 42). Inspite of it, in the absence of an agreement to the contrary, the retiring partner or the representative of a deceased partner can recover his share in the partnership assets (including goodwill), after having them revalued on a proper basis as at the date of his ceasing to be a partner; appreciation or depreciation determined on such a revaluation is adjusted in his account before the amount due to him is paid.

The amount due to the retiring partner is liability of the firm except where a partnership agreement provides that upon the retirement or death of a partner his share in the assets of the firm will be taken over by the continuing partners in the proportion in which they were sharing the profits or losses of the firm. When the continuing partners take over the assets they also become personally liable to repay the amount due to the retiring partner. Such was the view taken in the well known case of *Elliott* vs. *Elliott.*

Students should also remember that :

(1) the retiring partner or the estate of the deceased partner is liable for the whole of the debts due by the firm at the date of retirement or death though, as between the partners they are responsible to pay only their respective share of liabilities [Section 42(2) of the Partnership Act].

(2) the retiring partner may also be held liable for debts contracted after his retirement, unless a notice of retirement is published as contemplated by the Law [Section 32(2) of the Partnership Act]; and

(3) the estate of a deceased or a bankrupt partner cannot be held liable for debts contracted by the firm after the death or bankruptcy, as the case may be. [Sections 34(2) and 35 of the Partnership Act].

Dissolution before expiry of a fixed term: A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund if the firm is dissolved before the term has expired.

No claim in this respect will arise if:

(1) the firm is dissolved due to the death of a partner;

(2) the dissolution is mainly due to the partner's (claiming refund) own misconduct; and

(3) the dissolution is in pursuance of an agreement containing no provision for the return of

the premium or any part of it. [Section 50].

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

1.4 CLOSING OF PARTNERSHIP BOOKS ON DISSOLUTION

We will illustrate the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Fast and Quick as at Dec. 31, 2008

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals:			Sundry Debtors	19,000	
Fast	30,000		*Less:* Prov. for bad debts	1,000	18,000
Quick	25,000	55,000	Cash		6,000
		95,000			95,000

Fast and Quick shared profits in the ratio of 3:2. On 1st January, 2009 the firm was dissolved. Fast took over the patents at a valuation of Rs.5,000. The other assets realised as under:

		Rs.
Goodwill		15,000
Plant and Machinery		30,000
Stock		22,000
Sundry Debtors		18,500
	Total	85,500

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to Rs.3,500. The steps to close the books are given below:

I. Open a Realisation Account and transfer all assets except cash in hand or at bank at book values. Realisation Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be:

Realisation Account	Dr.	90,000	
To Plant and machinery Account			40,000
To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realisation Account)			

II. Transfer of liabilities to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realisation account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be:

		Rs.	*Rs.*
Sundry Creditors Account	Dr.	20,000	
Provision for bad Debts Account	Dr.	1,000	
To Realisation Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realisation Account)			

Note: Accounts denoting accumulated losses or profits should not be transferred to the Realisation Account.

III. (i) The Realisation Account should be credited with the actual amount realised by sale of assets. This should take no note of the book figures. Of course, Cash (or Bank) Account will be debited. Thus:

Cash Account	Dr.	85,500	
To Realisation Account			85,500
(Amount realised by sale of various assets)			

(ii) If a partner takes over an asset, his Capital Account should be debited and Realisation Account credited with the value agreed upon, Thus:

Fast's Capital Account	Dr.	5,000	
To Realisation Account			5,000
(Patents taken over by Fast at Rs. 5,000)			

IV. Expenses of dissolution or realisation of assets are debited to the Realisation Account and credited to Cash Account. Thus

Realisation Account	Dr.	3,500	
To Cash Account			3,500
(Payment of Expenses)			

V. (i) The actual amount paid to creditors should be debited to the Realisation Account and Cash Account is credited:

Realisation Account	Dr.	19,000	
To Cash Account			19,000
(Payment to Sundry Creditors, Rs. 20,000 less 5%)			

(ii) If any liability is taken over by a partner, his Capital Account should be credited and Realisation Account debited with the amount agreed upon.

VI. At this stage, the Realisation Account will show profit or loss. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit sharing ratio. In case of profit, Realisation Account is debited and Capital Accounts credited. The entry for loss is, naturally, reverse of this. The Realisation Account in the example given above shows a loss of Rs. 1,000 (see account below).

Fast's Capital Account	Dr.	600	
Quick's Capital Account	Dr.	400	
To Realisation account			1,000
(Transfer of loss to Capital Account in the ratio of 3:2)			

VII. Partner's Loans if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus:

Fast's Loan Account	Dr.	10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

VIII. Any reserve of accumulated profit or loss lying in the books (as shown by the Balance Sheet) should be transferred to the Capital Account in the profit sharing ratio. Thus:

General Reserve	Dr.	10,000	
To Fast's Capital Account			6,000

To Quick's Capital Account		4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)		

IX. At this stage the Capital Account will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the Capital Accounts as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below:

Fast's Capital Account	Dr.	30,400	
Quick's Capital Account	Dr.	28,600	
To Cash Account			59,000
(Amounts paid to partners on Capital Account)			

LEDGER ACCOUNTS

Plant and Machinery Account

2009		*Rs.*	*2009*		*Rs.*
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realisation A/c - Transfer	40,000

Patents Accounts

2009		Rs.	2009		Rs.
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realisation A/c - Transfer	6,000

Stock Account

2009		Rs.	2009		Rs.
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realisation A/c - Transfer	25,000

Sundry Debtors Account

2009		*Rs.*	*2009*		*Rs.*
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realisation A/c - Transfer	19,000

Provision for Bad Debts Account

2009		*Rs.*	*2009*		*Rs.*
Jan. 1	To Realisation A/c Transfer	1,000	Jan. 1	By Balance b/d	1,000

Sundry Creditors Account

2009		Rs.	2009		Rs.
Jan. 1	To Realisation A/c Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2009		Rs.	2009		Rs.
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000

General Reserve Account

2009			Rs.	2009		Rs.
Jan. 1	To Capital Account			Jan. 1	By Balance b/d	10,000
	Fast	6,000				
	Quick	4,000	10,000			
			10,000			10,000

Realisation Account

2009			Rs.	2009			Rs.
Jan.	To Sundry Assets			Jan.	By Sundry Creditors		20,000
	Plant and Machinery		40,000		By Provision for Bad Debts		1,000
	Patents		6,000		By Cash Account-		
	Stock		25,000		assets realised		85,500
	Sundry Debtors		19,000		By Fast's Capital Account-		
	To Cash Account-Exp.		3,500		patents taken over		5,000
	To Cash Account-						
	Creditors paid		19,000		By Loss to :		
					Fast	600	
					Quick	400	1,000
			1,12,500				1,12,500

Cash Account

2009		Rs.	2009		Rs.
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realisation A/c-Exp.	3,500
	To Realisation b/d	85,500	Jan. 1	By Realisation A/c-Creditors	19,000

			Jan. 1	By	Fast's Loan Acount	10,000
			Jan. 1	By	Fast's Capital A/c	30,400
			Jan. 1	By	Quick's Capital A/c	28,600
		91,500				91,500

Fast's Capital Account

2009		Rs.	2009		Rs.
Jan. 1	To Realisation A/c-Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realisation A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			
		36,000			36,000

Quick's Capital Account

2009		Rs.	2009		Rs.
Jan. 1	To Realisation A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	28,600		By General Reserve	4,000
		29,000			29,000

Note :

(1) If any of the assets is taken over by a partner at a value mutually agreed to by the partners, debit the partner's capital account and credit Realisation Account with the price of asset taken over.

(2) Pay off the liabilities, crediting cash and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realisation Account.

(3) Liabilities to outsiders may also be transferred to the Realisation Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realisation Account, Cash Account being credited. If liability is taken over by a partner, Realisation Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.

(4) The balance of the Realisation Account will represent either the profit or loss on realisation. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realisation Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.

(5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.

(6) The balance of the cash account at the end will be exactly equal to the balance of capital

account, provided they are in credit; credit cash and debit the partners' capital account with the amount payable to them to close their accounts.

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realised. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well known case of *Garner* vs. *Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

1.5 CONSEQUENCES OF INSOLVENCY OF A PARTNER

If a partner goes insolvent then the following are the consequences:

1. The partner adjudicated as insolvent ceases to be a partner.
2. He ceases to be a partner on the date on which the order of adjudication is made.
3. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.
4. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and
5. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

1.6 LOSS ARISING FROM INSOLVENCY OF A PARTNER

When a partner is unable to pay his debt due to the firm he is said to be insolvent and the share of loss is to be borne by other solvent partners in accordance with the decision in the English case of Garner vs. Murray. According to this decision, solvent partners have to bear the loss due to insolvency of a partner and has categorically put that the normal loss on realisation of assets to be borne by all partners (including insolvent partner) in the profit sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio. The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to *Garner* vs. *Murray* rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per deed should be applied.

Capital Ratio on Insolvency: The partners are free to have either fixed or fluctuating capitals in the firm. If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary etc. are done through Current Accounts, which may have debit or credit balances and insolvency loss is distributed in the ratio of fixed capitals. But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business shall not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and on drawings to the date of dissolution but before adjusting profit or loss on Realisation Account. If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear loss on account of the insolvency of other partner.

Insolvency of all Partners: When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances it is better not to transfer the amount of creditors to Realisation Account. Creditors may be paid the amount available including the amount contributed by the partners. The unsatisfied portion of creditor account is transferred to Capital Accounts of the partners in the profit sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

Illustration 1

P, Q and R were partners sharing profits and losses in the ratio of 3 : 2 : 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2008 is as follows :

Liabilities		*Rs.*	*Assets*		*Rs.*
Fixed Capital			Fixed assets :		
P	20,000		Goodwill		40,000
Q	20,000		Freehold Property		8,000
R	10,000	50,000	Plant and Equipment		12,800
Current Accounts :			Motor Vehicle		700
P	500		*Current Assets*		
Q	9,000	9,500	Stock		3,900
Loan from P		8,000	Trade Debtors	2,000	
Trade Creditors		12,400	*Less :* Provision	100	1,900
			Cash at Bank		200
			Miscellaneoous losses		
			R's Current Account		400
			Profit and Loss Account		12,000
		79,900			79,900

On 1st July, 2008 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of Rs.500 but no cash passed specifically in respect of this transaction. Sale of other assets realised the following amounts:

	Rs.
Goodwill	nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid Rs.11,700 in full settlement of their debts. The costs of dissolution amounted to Rs.1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to pay his creditors 1/3 of the amount due.

You are required to show:

(a) Cash and Bank Account,

(b) Realisation Account, and

(c) Partners Fixed and Current Accounts.

Solution

Cash/Bank Acount

		Rs.		Rs.
To Balance b/d		200	By Realisation A/c-Creditors	11,700
To Realisation A/c-			By Realisation A/c-Expenses	1,500
Freehold property		7,000	By P's Loan A/c	8,000
Plant and Equipment		5,000	By Q's Capital A/c	7,200
Stock		3,000		
Trade Debtors		1,600		
To Capital Accounts:				
P	11,300			
R	300	11,600		
		28,400		28,400

Realisation Account

	Rs.		Rs.
To Goodwill	40,000	By Trade Creditors	12,400
To Freehold Property	8,000	By Provision for Bad Debts	100
To Plant and Equipment	12,800	By Bank :	

To Motor Vehicle	700	Freehold Property	7,000	
To Stock	3,900	Plant and Equip.	5,000	
To Sundry Debtors	2,000	Stock	3,000	
To Bank (Creditors)	11,700	Debtors	1,600	16,600
To Bank (Expenses)	1,500	By Q (Car)		500
		By Capital Accounts : (Loss)		
		P	25,500	
		Q	17,000	
		R	8,500	51,000
	80,600			80,600

Partners' Capital Accounts

	P	Q	R		P	Q	R
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs*
To Current A/c (Transfer)	5,500	—	2,400	By Balance b/d	20,000	20,000	10,000
To Realisation A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer)	—	5,000	—
To Realisation A/c (Car)	—	500	—	By Bank	11,300	—	300
To R's Capital A/c (Deficiency)	300	300	—	By P & Q (Deficiency)	—	—	600
To Bank	—	7,200	—				
	31,300	25,000	10,900		31,300	25,000	10,900

Illustration 2

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 2008 when the firm was dissolved :

	Rs.		*Rs.*
Creditors A/c	4,800	Plant & Machinery	2,500
Amal's Capital A/c	750	Furniture	500
		Debtors	1,000
		Stock	800
		Cash	200
		Bimal's drawings	550
	5,550		5,550

The assets realised as under:

	Rs.
Plant & Machinery	1,250
Furniture	150
Debtors	400
Stock	500

The expenses of realisation amounted to Rs. 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of Rs. 200 only.

Show necessary ledger accounts to close the books of the firm.

Solution

In the books of M/s Amal and Bimal

Realisation Account

Dr.	*Rs.*			*Cr.* *Rs.*
2008		2008		
Mar. 31		Mar. 31		
To Sundry Assets :		By Cash A/c :		
Plant & Machinery	2,500	Plant & Machinery	1,250	
Furniture	500	Furniture	150	
Debtors	1,000	Debtors	400	
Stock	800	Stock	500	
Cash A/c-expenses	175			2,300
		By Partners' Capital A/c		
		Loss on realisation		
		Amal	1,337	
		Bimal	1,338	2,675
	4,975			4,975

Sundry Creditors Account

Dr.	*Rs.*		*Cr.* *Rs.*
2008		2008	
Mar. 31		Mar. 31	
To Cash A/c	2,525	By Balance b/d	4,800
" Deficiency A/c-transfer	2,275		
	4,800		4,800

Cash Account

Dr.			Cr.
	Rs.		Rs.
2008		2008	
Mar. 31		Mar. 31	
To Balance b/f	200	By Realisation A/c-	
" Realisation A/c		expenses	175
- Sale of sundry assets	2,300	" Sundry Creditors A/c	2,525
" Bimal's Capital A/c	200		
	2,700		2,700

Deficiency Account

Dr.			Cr.
	Rs.		Rs.
2008		2008	
Mar. 31		Mar. 31	
To Partners' Capital A/c		By Sundry Creditors A/c	2,275
Amal	587		
Bimal	1,688		
	2,275		2,275

Partners' Capital Account

Dr.					Cr.
	Amal Rs.	Bimal		Amal Rs.	Bimal
2008			2008		
Mar. 31			Mar. 31		
To Balance b/f	—	550	By Balance b/f	750	—
" Realisation A/c			" Cash A/c	—	200
- loss	1,337	1,338	" Deficiency		
			A/c- transfer	587	1,688
	1,337	1,888		1,337	1,888

Illustration 3

A ,B, C and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2008 when their balance sheet was as under :-

Liabilities		*Rs.*	*Assets*	*Rs.*
Creditors		15,700	Bank	535
Employees Provident Fund		6,300	Debtors	15,850
Capital Accounts :-			Stock	25,200
A	40,000		Prepaid Expenses	800
B	20,000	60,000	Plant & Machinery	20,000
			Patents	8,000
			C's Capital A/c	3,200
			D's Capital A/c	8,415
		82,000		82,000

Following information is given to you :-

1. One of the creditors took some of the patents whose book value was Rs. 5,000 at a valuation of Rs. 3,200. Balance of the creditors were paid at a discount of Rs. 400 .
2 There was a joint life policy of Rs. 20,000 (not mentioned in the balance sheet) and this was surrendered for Rs. 4,500.
3 The remaining assets were realised at the following values :- Debtors Rs.10,800; Stock Rs.15,600; Plant and Machinery Rs.12,000; and Patents at 60% of their book-values. Expenses of realisation amounted Rs. 1,500.

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firms claim against his estate. Prepare necessary ledger accounts.

Solution

Realisation Account

		Rs.				*Rs.*
To Sundry Assets :-			By	Creditors		15,700
Debtors	15,850		By	Employee's Provident Fund		6,300
Stock	25,200		By	Bank A/c :-		
Prepaid Expenses	800			Joint Life Policy	4,500	
Plant & Machinery	20,000			Debtors	10,800	
Patents	8,000	69,850		Stock	15,600	
				Plant and Machinery	12,000	
To Bank (Creditors Rs.15,700				Patents		
Rs. 3,200-Rs. 400)		12,100		(60% of Rs. 3,000)	1,800	44,700

	Rs.			Rs.	Rs.
To Bank A/c Employee's (P.F)	6,300				
To Bank A/c (expenses)	1,500	By	Loss transferred to :-		
			A's Capital	9,220	
			B's Capital	6,915	
			C's Capital	4,610	
			D's Capital	2,305	23,050
	89,750				89,750

Capital Accounts

	A	B	C	D		A	B	C	D
	Rs.	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.	Rs
To Bal. b/d	—	—	3,200	8,415	By Bal. b/d	40,000	20,000	—	—.
To Realisation A/c	9,220	6,915	4,610	2,305	By Bank (Recovery)	—	—	—	2,680
To D's Capital (Deficiency)	5,360	2,680	—	—	By A's Capital 2/3	—	—	—	5,360
To Bank	25,420	10,405	—	—	By B's Capital 1/3	—	—	—	2,680
					By Bank A/c	—	—	7,810	—
	40,000	20,000	7,810	10,720		40,000	20,000	7,810	10,720

Bank Acount

	Rs.		Rs.
To Balance b/d	535	By Realisation A/c	12,100
To Realisation A/c	44,700	By Realisation A/c	6,300
To D's Capital A/c	2,680	By Realisation A/c	1,500
To C's Capital A/c	7,810	By A's Capital A/c	25,420
		By B's Capital A/c	10,405
	55,725		55,725

Working Note :- D's Loss will be borne by only A and B. C will bring his share of loss in cash.

Illustration 4

M/s X, Y and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as at December 31, 2008.

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
Capital : X	29,200		Fixed Assets		40,000
Y	10,800		Stock		25,000
Z	10,000	50,000	Book Debts	25,000	
Z's Loan		5,000	*Less* : Provision	5,000	20,000
Loan from Mrs. X		10,000	Cash		1,000
Sundry Trade Creditors		25,000	Advance to Y		4,000
		90,000			90,000

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to Rs. 4,000 have been purchased in November, 2008 and had been received but the purchase was not recorded in books.

Fixed assets realised Rs. 20,000; Stock Rs. 21,000 and Book Debt Rs. 20,500. Similarly, the creditors allowed a discount of 2% on the average. The expenses of realisation come to Rs. 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in *Garner* vs. *Murray.*

Solution

Realisation Account

		Rs.				*Rs.*
To	Sundry		By	Provision for Bad Debt		5,000
	Fixed Assets (transfer)	40,000	By	Cash		61,500
	Stock	25,000	By	Sundry Trade Creditors		
	Book Debts	25,000		(Discount)		580
To	Cash—Expenses	1,080	By	Loss : X 2/5	9,600	
				Y 2/5	9,600	
				Z 1/5	4,800	24,000
		91,080				91,080

Sundry Trade Creditors

		Rs.			Rs.
To	Realisation A/c - Discount		By	Balance b/d	25,000
	@ 2% on Rs. 29,000	580	By	Sundry Capital Accounts	
To	Cash	28,420		(Purchase omitted)	4,000
		29,000			29,000

Z's Loan Account

To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

To X's Capital A/c - transfer	10,000	By Balance b/d	10,000

Cash Account

	Rs.		Rs.
To Balance b/d	1,000	By Sundry Trade Creditors	28,420
To Realisation A/c-		By Realisation A/c - expenses	1,080
assets realised	61,500	By Z's Loan	5,000
To X's Capital A/c*	9,600	By X's Capital A/c	34,300
To Z's Capital A/c*	4,800	By Z's Capital A/c	8,100
	76,900		76,900

*X and Z bring these amounts to make good their share of the loss on realisation. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

	X	Y	Z		X	Y	Z
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Sundry Trade				By Balance b/d	29,200	10,800	10,000
Creditors- omission	1,600	1,600	800				
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance	-	4,000	-	By Balance b/d	27,600	9,200	9,200
To Realisation A/c- loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000	-	-
To Y's Capital A/c	3,300	-	1,100	By Cash	9,600	-	4,800
				By X's Capital A/c	-	3,300	-
To Cash	34,300	-	8,100	By Z's Capital A/c	-	1,100	-
	47,200	13,600	14,000		47,200	13,600	14,000

Note : Y's deficiency comes to Rs. 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600 : 9,200 *i.e.,* capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2008.

Illustration 5

'Thin', 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.

On 30th September, 2008 their Balance Sheet was as follows :

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts :			Premises	50,000
Thin	80,000		Fixtures	1,25,000
Short	50,000		Plant	32,500
Fat	20,000	1,50,000	Stock	43,200
Current Accounts :			Debtors	54,780
Thin	29,700			
Short	11,300			
Fat (Dr.)	(14,500)	26,500		
Sundry Creditors		84,650		
Bank Overdraft		44,330		
		3,05,480		3,05,480

'Thin' decides to retire on 30th September, 2008 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of partnership, so all three partners decide to dissolve the partnership with effect from 30th September, 2008. It then transpires that 'Fat' has no private assets whatsoever,

The premises are sold for Rs. 60,000 and the plant for Rs. 1,07,500. The fixtures realise Rs. 20,000 and the stock is acquired by another firm at book value less 5%. Debtors realise Rs. 45,900. Realisation expenses amount to Rs. 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in *Garner* vs. *Murray* :

(i) Realisation Account ;

(ii) Partners' Current Accounts ;

(iii) Partners' Capital Accounts showing the closing of the firm's books.

Solution

Realisation Account

2008	*Rs.*	*2008*		*Rs.*
Sept. 30		Sept.30		
To Premises	50,000	By Sundry Creditors		84,650
To Plant	1,25,000	By Bank :		
To Fixtures	32,500	Premises	60,000	

To Stock	43,200		Plant	1,07,500	
To Debtors	54,780		Fixtures	20,000	
To Bank (Creditors)	84,650		Stock	41,040	
To Bank (Expenses)	4,500		Debtors	45,900	2,74,440
		By	Loss on Realisation transferred to Partners' Current A/cs		
			Thin	14,216	
			Short	14,216	
			Fat	7,108	35,540
	3,94,630				3,94,630

Partners' Current Accounts

2008		Thin Rs.	Short Rs.	Fat Rs.	2008		Thin Rs.	Short Rs.	Fat Rs.
Sept. 30	To Balance b/d	–	–	14,500	Sept. 30	By Balance b/d	29,700	11,300	–
	To Realisation	14,216	14,216	7,108		By Capital A/c Transfer	–	2,916	21,608
	To Capital A/c transfer	15,484	–	–					
		29,700	14,216	21,608			29,700	14,216	21,608

Partners' Capital Accounts

2008		Thin Rs.	Short Rs.	Fat Rs.	2008		Thin Rs.	Short Rs.	Fat Rs.
Sept., 30	To Current A/c	–	2,916	21,608	Sept., 30	By Balance b/d	80,000	50,000	20,000
	To Fat's Capital A/c Deficiency in the ratio of 8:5	990	618	–		By Current A/c (transfer)	15,484	–	–
	To Bank	94,494	46,466	–		By Thin & Short Capital A/cs			1,608
		95,484	50,000	21,608			95,484	50,000	21,608

Working Notes

(i) **Bank Account**

	Rs.		Rs.
To Realisation A/c	2,74,440	By Balance b/d	44,330
		By Realisation A/c (Creditors)	84,650

		By Realisation A/c (Expenses)	4,500
		By Thin's Capital A/c	94,494
		By Short's Capital A/c	46,466
	2,74,440		2,74,440

(ii) Fat's deficiency has been borne by Thin & Short in the ratio of their fixed capitals *i.e.,* 8:5 following the rule in *Garner* vs. *Murray*.

1.7 PIECEMEAL PAYMENTS

Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

1.7.1 Maximum Loss Method : Each instalment realised is considered to be the final payment *i.e.,* outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either *Garner* vs. *Murray* Rule or the profit-sharing ratio rule.

Illustration 6

The following is the Balance Sheet of A, B, C on 31st December, 2005 when they decided to dissolve the partnership:

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,000	Sundry Assets	48,500
A's Loan	5,000	Cash	500
Capital Accounts :			
A	15,000		
B	18,000		
C	9,000		
	49,000		49,000

The assets realised the following sums in instalments :

I	1,000
II	3,000
III	3,900
IV	6,000
V	20,100
	34,000

The expenses of realisation were expected to be Rs. 500 but ultimately amounted to Rs. 400

only.

Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

Solution

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

Statement showing Realisation and Distribution of Cash Payments

		Realisation	*Creditors*	*Partners' Loan*	*Partners' Capitals*
		Rs.	*Rs.*	*Rs.*	*Rs.*
1.	After taking into account cash balance and amount set aside for expenses	1,000	1,000	-	-
2.		3,000	1,000	2,000	-
3.		3,900	-	3,000	900
4.		6,000	-	-	6,000
5.	Including saving in expenses	20,100	-	-	20,100
		34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each instalment realised among the partners, the following table will be constructed:

Statement of Distribution on Capital Account

(1) Calculation to determine the mode of distribution of Rs. 900

	Total	*A*	*B*	*C*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless	41,100	16,440	16,440	8,220
	+ 900	– 1,440	+ 1,560	+ 780
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000 : 9,000 (*Garner* vs. *Murray*)			960	480
Manner in which the first Rs. 900 should be distributed			+ 600	+ 300

(2) *Distribution of Rs. 6,000*

Balance after making payment of

	amount shown in step (1)	41,100	15,000	17,400	8,700
	Less : Possible Loss assuming remaining asset to be valueless	35,100	14,040	14,040	7,020
	Balance available and to be distributed	6,000	960	3,360	1,680
(3)	*Distribution of Rs. 20,100*				
	Balance after making payment of amount shown in step (2)	35,100	14,040	14,040	7,020
	Less : Possible loss, assuming remaining assets to be valueless	15,000	6,000	6,000	3,000
	Manner of distribution of Rs. 20,100	20,100	8,040	8,040	4,020
	Summary :				
	Balance	42,000	15,000	18,000	9,000
	Total amounts paid	27,000	9,000	12,000	6,000
	Loss	15,000	6,000	6,000	3,000

1.7.2 Highest Relative Capital Method : According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital ; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

		A	*B*	*C*
Capital	Rs.	15,000	18,000	9,000
Profit-sharing ratio		2	2	1
Capital divided by the profit-sharing ratio		7,500	9,000	9,000

Proportionate Capital of B and C, taking				
A's capital as the base	Rs.	15,000	15,000	7,500
Excess of actual over proportionate capital	Rs.	nil	3,000	1,500

This indicates that A should not get anything till Rs. 3,000 is paid to B and Rs. 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method:

	Total	*A*	*B*	*C*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Third Instalment	900	-	600	300
Fourth Instalment (*i*)	3,600	-	2,400	1,200
(*ii*)	2,400	960	960	480
Fifth Instalment	20,100	8,040	8,040	4,020
Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

Illustration 7

The partners A, B and C have called you to assist them in winding up the affairs of their partnership on 30th June, 2005. Their Balance Sheet as on that date is given below :

Liabilities	*Rs.*	*Assets*	*Rs.*
Sundry Creditors	17,000	Cash at Bank	6,000
Capital Accounts :		Sundry Debtors	22,000
A	67,000	Stock in trade	14,000
B	45,000	Plant and Equipment	99,000
C	31,500	Loan-A	12,000
		Loan-B	7,500
	1,60,500		1,60,500

(1) The partners share profit and losses in the ratio of 5:3:2

(2) Cash is distributed to the partners at the end of each month

(3) A summary of liquidation transactions are as follows:

July 2005

Rs. 16,500 - collected from Debtors; balance is uncollectable.

Rs. 10,000 - received from sale of entire stock.

Rs. 1,000 - liquidation expenses paid.

Rs. 8,000 - cash retained in the business at the end of the month.

August 2005

Rs. 1,500 – liquidation expenses paid. As part payment of his Capital, C accepted a piece of equipment for Rs. 10,000 (book value Rs. 4,000).

Rs. 2,500 – cash retained in the business at the end of the month.

September 2005

Rs. 75,000 – received on sale of remaining plant and equipment.

Rs. 1,000 – liquidation expenses paid. No cash retained in the business.

Required : Prepare a schedule of cash payments as of September 30, showing how the cash was distributed.

Solution

Statement showing distribution of cash

		Creditors	Capitals		
	Rs.	*Rs.*	*A(Rs.)*	*B(Rs.)*	*C(Rs.)*
Balance Due		17,000	55,000	37,500	31,500
July					
Balance available	6,000				
Realisation less expenses and cash retained	17,500				
Amount available and paid	23,500	17,000			6,500
Balance due		—	55,000	37,500	25,000
August					
Opening balance	8,000				
Expenses paid and balance carried forward	4,000				
Available for distribution	4,000				
Cash paid to 'B' and Equipment given to C.			—	4,000	10,000
(Excess paid to 'C' Rs. 7,333)			55,000	33,500	15,000
September					
Opening balance	2,500				
Amount realised less expenses	74,000				
Amount paid to partners	76,500		41,500	25,400	9,600
			13,500	8,100	5,400

Working Note:

(i) **Highest Relative Capital Basis**

	A	B	C
	Rs.	*Rs.*	*Rs.*
Scheme of payment for July			
Balance of Capital Accounts	67,000	45,000	31,500
Less : Loans	12,000	7,500	—
	55,000	37,500	31,500
Profit sharing ratio	5	3	2
Capital Profit sharing ratio	11,000	12,500	15,750
Capital in profit sharing ratio taking A's Capital as base	55,000	33,000	22,000
Excess of C's Capital and B's Capital		4,500	9,500
Excess of C's Capital over B		(9,500 – 3,000)	6,500

(ii) **Scheme of distribution of available cash:**

	A	B	C
Scheme of payment for September			
Balance of Capital Accounts	55,000	33,500	15,000
Profit Sharing Ratio	5	3	2
Capital/Profit sharing Ratio	11,000	11,167	7,500
Capital in profit sharing ratio taking C's Capital as base	37,500	22,500	15,000
Excess of A's Capital and B's Capital	17,500	11,000	
Excess in Profit Sharing Ratio	3,500	3,667	
Excess in profit sharing Ratio taking A's excess as base	17,500	10,500	
Excess	–	500	–
Payment Rs. 500		(500)	
Balance of Excess	17,500	10,500	
Payment Rs. 28,000	(17,500)	(10,500)	
Balance	37,500	22,500	15,000
Payment (Rs.76,500 – Rs.28,500) Rs.48,000	(24,000)	(14,400)	(9,600)
Loss	13,500	8,100	5,400
Total Payment Rs. 76,500	41,500	25,400	9,600

Illustration 8

The firm of LMS was dissolved on 31.3.2005, at which date its Balance Sheet stood as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	2,00,000	Fixed Assets	45,00,000
Bank Loan	5,00,000	Cash and Bank	2,00,000
L's Loan	10,00,000		
Capital			
L	15,00,000		
M	10,00,000		
S	5,00,000		
	47,00,000		47,00,000

Partners share profits equally. A firm of Chartered Accountants is retained to realise the assets and distribute the cash after discharge of liabilities. Their fees which include all expenses is fixed at Rs. 1,00,000. No loss is expected on realisation since fixed assets include valuable land and building.

Realisations are:

S.No.	Amount in Rs.
1	5,00,000
2	15,00,000
3	15,00,000
4	30,00,000
5	30,00,000

The Chartered Accountant firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

Solution

In the Books of M/s LMS
Statement of Piecemeal Distribution (Under Higher Relative Capital method)

Particulars	*Amount available*	*Creditors*	*Bank Loan*	*L's loan*	*Capital A/cs L*	*M*	*S*
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Balance due		2,00,000	5,00,000	10,00,000	15,00,000	10,00,000	5,00,000

1st Instalment (including cash and bank balances)	5,00,000						
Less: Liquidator's Expenses and fees	1,00,000						
	4,00,000						
Less: Payment to Creditors and repayment of Bank Loan in the ratio of 2:5	(4,00,000)	(1,14,286)	(2,85,714)	–	–	–	–
Balance Due	–	85,714	2,14,286	10,00,000	15,00,000	10,00,000	
5,00,000							
2nd Instalment	15,00,000						
Less: Payment to Creditors and repayment of bank loan in full settlement	(3,00,000)	(85,714)	(2,14,286)	–	–	–	–
	12,00,000	–	–				
Less: Repayment of L's Loan	(10,00,000)			(10,00,000)	–	–	–
	2,00,000						
Less: Payment to Mr. L towards relative higher capital (W.N. 1)	(2,00,000)				(2,00,000)	–	—
					13,00,000	10,00,000	5,00,000
Balance Due							
3rd Instalment	15,00,000						
Less: Payment to Mr. L towards higher relative capital (W.N. 2)	(3,00,000)				(3,00,000)		
	12,00,000				10,00,000		
Less: Payment to Mr. L & Mr. M towards excess capital (W.N. 1&2)	(10,00,000)				(5,00,000)	(5,00,000)	
	2,00,000				5,00,000	5,00,000	
Less: Payment to all the partners equally	(2,00,000)				(66,667)	(66,667)	(66,666)
					4,33,333	4,33,333	4,33,334
Balance due							
4th Instalment	30,00,000						

			L	M	S
Less:	Payment to all the partners equally	(30,00,000)	(10,00,000)	(10,00,000)	(10,00,000)
	Realisation profit credited to Partners		5,66,667	5,66,667	5,66,666
	5th Instalment	30,00,000			
	Less: payment to all partners equally	(30,00,000)	10,00,000	10,00,000	10,00,000
Realisation profit credited to partners			15,66,667	15,66,667	15,66,666

Working Notes:

(i) Scheme of payment of surplus amount of Rs. 2,00,000 out of second Instalment:

		Capital A/cs	
	L	*M*	*S*
	Rs.	*Rs.*	*Rs.*
Balance (i)	15,00,000	10,00,000	5,00,000
Profit sharing ratio (ii)	1	1	1
Capital taking S's Capital (iii)	5,00,000	5,00,000	5,00,000
Excess Capital (iv) = (i) – (iii)	10,00,000	5,00,000	
Profit Sharing Ratio	1	1	
Excess capital taking M's Excess Capital as base (v)	5,00,000	5,00,000	
Higher Relative Excess (iv) – (iv)	5,00,000		

So, Mr. L should get Rs. 5,00,000 first which will bring down his capital account balance from Rs. 15,00,000 to Rs. 10,00,000. Accordingly, surplus amounting to Rs. 2,00,000 will be paid to Mr. L towards higher relative capital.

(ii) Scheme of payment of Rs. 15,00,000 realised in 3rd Instalment:

– Payment of Rs. 3,00,000 will be made to Mr. L to discharge higher relative capital. This makes the higher capital of both Mr. L and Mr. M Rs. 5,00,000 as compared to capital of Mr. S.

– Payment of Rs. 5,00,000 each of Mr. L & Mr. M to discharge the higher capital.

– Balance Rs. 2,00,000 equally to L, M and S, i.e., Rs. 66,667 Rs. 66,667 and Rs. 66,666 respectively.

Self-Examination Questions

I. Objective type questions

Pick up the most appropriate answer from the given options:

1. On the dissolution of partnership, profit or loss on realization should be divided among partners
   - (a) In the ratio of their capitals.
   - (b) In the same ratio in which they share profits.
   - (c) Equally.
   - (d) None of the above.
2. An unrecorded asset realized at the time of dissolution is credited to
   - (a) Realization account.
   - (b) Revaluation account.
   - (c) Capital accounts.
   - (d) Cash account.
3. A liability taken over by a partner at the time of dissolution is credited to
   - (a) Profit and loss account.
   - (b) Partners' capital accounts.
   - (c) Realization account.
   - (d) Revaluation account.
4. Realization account is a
   - (a) Nominal account.
   - (b) Real account.
   - (c) Personal account.
   - (d) None of the above.
5. As per Garner vs Muray rule, any losses arising due to capital deficiency of insolvent partners are to be divided among solvent partners
   - (a) In the ratio of capitals after adjusting realization losses or gains and accumulated profits and losses.

- (b) In the ratio of capitals before adjusting realization losses or gains and accumulated profits and losses.
- (c) In the ratio of capitals after adjusting accumulated profits and losses but before adjusting realization losses or gains.
- (d) In the ratio of capitals after adjusting realization losses or gains but before adjusting accumulated profits and losses.

[**Answers : 1.** (b); **2** (a); **3**. (b); **4**. (a); **5**. (a)]

II. Short answer type questions

6. Explain Garner Vs. Murray Rule.
7. What is realization account? How does it differ from revaluation account?
8. How should accounts be finally adjusted when all partners are insolvent? Explain in brief.

III. Long answer type questions

9. What do you mean by dissolution of a partnership firm? Give the entries required to close the books of the firm upon its dissolution.
10. How is debit balance of a partner's capital account is treated in the event of dissolution of firm. Explain with the help of an example.

IV. Practical problems

11. P, Q and R carrying on business as merchants and sharing profits and losses in the ratio of 2:2:1, dissolved their firm as on December 31, 2005 on which date their Balance Sheet was as follows :

Liabilities		*Rs.*	*Assets*		*Rs.*
Sundry Creditors		20,300	Cash at Bank		4,800
Reserve		10,000	Stock		16,000
Joint Life Policy reserve		8,000	Debtors	10,000	
Capital Accounts :			*Less :* Provision	500	9,500
P	15,000		Joint Life Policy		11,000
Q	15,000		Premises		30,000
R	3,000	33,000			
		71,300			71,300

Note : There is a bill for Rs. 1,000 under discount. The bill was received from Z.

The assets except cash at bank was realised for Rs. 65,150 and joint Life Policy was surrendered at Rs. 11,300, Z proved insolvent and a dividend of 5% was received from his estate. Sundry creditors were paid Rs. 19,500 in full settlement. Expenses amounted to Rs. 3,000.

Prepare Realisation Account, Cash Account and the partners' Capital Accounts.

12. A, B, C were in partnership. On 1.1.2006 A becomes insolvent and the firm was dissolved. Capital A/c balances of the partners on that date were A Rs. 50,000, B Rs. 40,000 and C Rs. 10,000. Loss on realisation Rs. 80,000 A, B and C were sharing profits and losses at the ratio of 2:2:1. Find out the ratio at which loss arising out of C's insolvency is to be borne by A and B.

A, B, C and D are partners sharing 4:3:2:1. Their position statement was as follows:-

Liabilities	*Amount (Rs.)*	*Assets*	*Amount (Rs.)*
Bank Loan	25,000	Cash	11,500
Creditors	50,000	Building	49,000
A's Capital	30,000	Stock	60,000
B's Capital	20,000	C's Capital	3,500
		D's Capital	1,000
	1,25,000		1,25,000

The firm is dissolved. All assets realised Rs.87,000. Bank loan is settled at Rs.24,000 and Creditors for Rs.49,500. There were outstanding expenses for Rs.400 and were settled by paying Rs.300. The expenses on dissolution are Rs.800. D becomes insolvent and C paid only Rs.3,000. Prepare ledger accounts to close the books of the firm.

13. On 1st January 2003 A, B, and C commenced business in partnership sharing profit and losses in proportion of ½, 1/3,and 1/6 respectively. They paid into their Bank A/c as their

Capital Rs.22,000 being Rs.10,000 by A, Rs.7,000 by B and Rs.5,000 by C. During the year they drew Rs.5,000, being Rs.1,900 by A, Rs.1,700 by B and Rs.1,400 by C.

On 31st December, 2005 they dissolve their partnership. A taking up stock at an agreed valuation of Rs.5,000, B taking up furniture at Rs.2,000 and C taking up debtors at Rs.3,000. After paying up their creditors, there remained a balance of Rs.1,000 at Bank. Prepare the necessary accounts showing the distribution of the cash at the Bank and of the further cash brought in by any partner as the case required.

14. Applying *Garner* vs. *Murray* rule close off the accounts of the firm, the Balance Sheet of which is given below. Partners were sharing profits equally.

Liabilities	*Rs.*	*Assets*	*Rs.*
Ram Pal's Capital	20,000	Plant & Machinery	12,000
Roy's Capital	10,000	Buildings	5,000
Trade Creditors	5,000	Trade Debtors	7,000
		Stock-in-trade	6,000
		Funny's Capital Account	5,000
	35,000		35,000

The assets were sold for Rs. 19,000 and expenses of the sale amounted to Rs. 1,000.

15. A, B and C have been suffering losses for many years and on December 31, when their balance sheet was drawn up as given below, they decided to dissolve up partnership. They shared profits in the ratio of 1/2, 1/3, 1/6.

Capital Accounts	*Rs.*	*Rs.*	*Fixed Assets*	*Rs.*
A	3,000		Goodwill	3,000
B	1,500		Fixture & Furniture	2,000
C	100	4,600	Leasehold Property	5,000
			Current Assets	
Current Accounts			Stock	10,000
A	500		Debtors	25,000
B	200		Cash	100
C (Debit)	(200)	500		
Current Liabilities & Provisions				
Trade Creditors		35,000		
Bank overdraft		5,000		
		45,100		45,100

There was a contingent liability in respect of a suit filed against the partners for a sum of Rs. 1,000.

The furniture and fixtures realised Rs. 1,800 on auction. The leasehold property has only three years to run. A agreed to take it over for Rs. 400. The stock realised Rs. 9,000 and Debtors Rs. 20,000. In the balance of Debtors Rs. 5,000 was not bad, they were slow - paying. It was mutually agreed that A and B should equally take them over at their book values. The liabilities were discharged at book values. The suit was decided against the firm and the firm paid Rs. 1,000 to the complainant plus Rs. 80 on account of costs. A and B were of means, but C was insolvent and his estate paid dividend of 25 p. in the rupee.

Prepare Realisation Account and close off the books of the firm.

16. Following is the Balance Sheet of Alpha & Co. as on 31st December consisting of 3 partners, A, B and C. As per the Deed, their capitals are fixed and they share profits and losses equally.

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors	1,02,400	Bank Balance	5,500
Loans :		Debtors	96,060
A	30,000	Stock	64,000
B	12,000	Machinery	28,600
Current Accounts :		Land & Building	84,000
A	21,200	Current Account	9,940
B	2,500		
Capital Accounts :			
A	60,000		
B	40,000		
C	20,000		
	2,88,100		2,88,100

The firm was dissolved on the above said date. All assets other than the bank balance realised net Rs. 2,26,880. The partner C is insolvent. Show the realisation and division amongst the partners.

UNIT - 2 : AMALGAMATION, CONVERSION AND SALE OF PARTNERSHIP FIRMS

Learning Objectives

After studying this unit, you will be able to :

- Understand the procedure for amalgamation of partnership firms.
- Learn the accounting treatment when a partnership firm is converted in the form of a company.
- Distribute the shares received as purchase consideration among the partners.

2.1 AMALGAMATION OF PARTNERSHIP FIRMS

The accounting procedures:

(a) Each firm should prepare a Revaluation Account relating to its own assets and liabilities and transfer the balance to the partners' capital accounts in the profit-sharing ratio.

(b) Entries for raising goodwill should be passed.

(c) Assets and liabilities not taken over by the new firm should be transferred to the capital accounts of partners in the ratio of their capitals.

(d) The new firm should be debited with the difference between the value of assets and liabilities taken over by it; the assets should be credited and liabilities debited.

(e) Partners' capital accounts should be transferred to the new firm's account;

The above steps will close the books of the old firm. To open the books of the new firm the following entries will be required;
Debit assets taken out at the agreed values

Credit the liabilities taken over, and

Credit individual partner's capital accounts with the closing balances in the erstwhile firm.

When one firm is merged with another existing firm, entries will be in the pattern of winding up in the books of the firm which has ceased to exist. The other firm will record the transaction as that of a business purchase.

Illustration 1

B and S are partners of S & Co. sharing profits and losses in the ratio of 3:1. S and T are partners of T & Co. sharing profits and losses in the ratio of 2:1.

On 31st October, 2006, they decided to amalgamate and form a new firm M/s. BST & Co. wherein

B, S and T would be partners sharing profits and losses in the ratio of 3:2:1.
Their balance sheets on that date were as under :

Liabilities	*S & Co.*	*T & Co.*	*Assets*	*S & Co.*	*T & Co.*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Due to X & Co.	40,000	–	Cash in hand	10,000	5,000
Due to S & Co.	–	50,000	Cash at bank	15,000	20,000
Other Creditors	60,000	58,000	Due from T & Co.	50,000	–
Reserve	25,000	50,000	Due from X & Co.	–	30,000
Capitals			Other Debtors	80,000	1,00,000
B	1,20,000	–	Stock	60,000	70,000
S	80,000	1,00,000	Furniture	10,000	3,000
T	–	50,000	Vehicles	–	80,000
			Machinery	75,000	–
			Building	25,000	
	3,25,000	3,08,000		3,25,000	3,08,000

The amalgamated firm took over the business on the following terms :

(a) Goodwill of S & Co. was worth Rs. 60,000 and that of T & Co. Rs. 50,000. Goodwill account was not to be opened in the books of the new firm, the adjustments being recorded through capital accounts of the partners.

(b) Building, machinery and vehicles were taken over at Rs. 50,000, Rs. 90,000 and Rs. 1,00,000 respectively.

(c) Provision for doubtful debts has to be carried forward at Rs. 4,000 in respect of debtors of S & Co. and Rs. 5,000 in respect of debtors of T & Co.

You are required to :

(i) Compute the adjustments necessary for goodwill.

(ii) Pass the journal entries in the books of BST & Co. assuming that excess/deficit capital (taking T's Capital as base) with reference to share in profits are to be transferred to current accounts.

Solution

(i) Adjustment for raising & writing off of goodwill :

	Raised in old profit sharing ratio				Written off in new ratio		Difference	
	S & Co.	**T & Co.**	**Total**					
	Rs.	*Rs.*	*Rs.*		*Rs.*		*Rs.*	
B	45,000	-	45,000	Cr.	55,000	Dr.	10,000	Dr.
S	15,000	33,333	48,333	Cr.	36,666	Dr.	11,667	Cr.
T	–	16,667	16,667	Cr.	18,334	Dr.	1,667	Dr.
	60,000	50,000	1,10,000		1,10,000			

Books of BST & Co.

Journal

			Dr.	*Cr.*
2006			Rs.	Rs.
Oct. 31	Cash Account	Dr.	10,000	
	Bank Account	Dr.	15,000	
	T & Co.	Dr.	50,000	
	Sundry Debtors	Dr.	80,000	
	Stock Account	Dr.	60,000	
	Furniture Account	Dr.	10,000	
	Machinery Account	Dr.	90,000	
	Building Account	Dr.	50,000	
	To Provision for Doubtful debts			4,000
	To X & Co.			40,000
	To Sundry Creditors			60,000
	To B's Capital Account			1,65,750
	To S's capital Account			95,250
	(Sundry assets and liabilities of M/s S & Co. taken over at the values stated as per agreement dated.....)			

Cash Account	Dr.	5,000	
Bank Account	Dr.	20,000	
X & Co. Account	Dr.	30,000	
Sundry Debtors A/c	Dr.	1,00,000	
Stock Account	Dr.	70,000	
Furniture Account	Dr.	3,000	
Vehicles Account	Dr.	1,00,000	
To Provision for Doubtful Debts			5,000
To S & Co.			50,000
To Sundry Creditors			58,000
To S's Capital Account			1,43,333
To T's Capital Account			71,667
(Sundry assets and liabilities of M/s T & Co. taken over at the values stated as per agreement dated...)			
B's Capital Account	Dr.	10,000	
T's Capital Account	Dr.	1,667	
To S's Capital Account			11,667
(Adjustment in capital accounts consequent on raising goodwill of S & Co. for Rs. 60,000, T & Co. for Rs. 50,000 and writing off the same in the new ratio between B,S,T as per agreement)			
S & Co.	Dr.	50,000	
To T & Co.			50,000
(Mutual indebtedness of S & Co. and T & Co., cancelled on taking over of the two firms)			
B's Current Account	Dr.	54,250	
To B's Capital Account			54,250
(Amount credited to B's Capital to bring capital in profit-sharing ratio)			
S's Capital Account	Dr.	1,10,250	
To S's Current Account			1,10,250
(Excess amount in S's Capital Account transferred to S's Current Account to reduce the balance in capital accounts			

in accordance with the profit sharing ratio)

Working Notes :

(i) Balance of Capital Accounts on transfer of business to M/s BST & Co.

(a) S & Co.		*B's Capital*	*S's Capital*
	Rs.	*Rs.*	*Rs.*
As per Balance Sheet		1,20,000	80,000
Credit for Reserve		18,750	6,250
Profit on Revaluation	40,000		
Less : Provision for Doubtful debts	4,000	27,000	9,000
		1,65,750	95,250

(b) T & Co.		*S's Capital*	*T's Capital*
	Rs.	*Rs.*	*Rs.*
As per Balance Sheet		1,00,000	50,000
Credit for Reserve		33,333	16,667
Profit on Revaluation	20,000		
Less : Provision for Doubtful Debts	5,000	10,000	5,000
		1,43,333	71,667

(ii) Capital in the new firm	*B*		*S*		*T*
	Rs.		*Rs.*		*Rs.*
Balance as taken over	1,65,750		95,250		-
	-		1,43,333		71,667
	1,65,750		2,38,583		71,667
Adjustment for Goodwill	–10,000		+11,667		–1,667
	1,55,750		2,50,250		70,000
Total capital, Rs. 4,20,000* in the new ratio of 3:2:1, taking T's Capital as the basis	2,10,000		1,40,000		70,000
Transfer to Current Account	54,250	(Dr.)	1,10,250	(Cr.)	—

*T's Capital is Rs. 70,000 and it is 1/6 of total. The total therefore is Rs. 4,20,000.

Illustration 2

On 31st March 2006, Sri Raman acquires on payment of Rs. 80,000 the business of

M/s Gupta and Singh taking over at book value the following assets and liabilities :

	Rs.
Debtors	35,000
Furniture	3,000
Stock	46,000
Creditors	10,000

There was no change between 1st January, 2006 and 31st March, 2006 in the book value of the assets and liabilities not taken over.

The same set of books has been continued after the acquisition and no entries of the acquisition have been passed except for the payment of Rs. 80,000 made by Sri Raman.

From the following balance sheet and trial balance prepare Business Purchase Account, Profit and Loss Account for the year ended 31st December, 2006 and Balance Sheet at that date.

Balance Sheet as at December, 2005

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts			Furniture	3,000
Sri Gupta	30,000		Investments	5,000
Sri Singh	20,000	50,000	Insurance Policy	2,000
Bank Loan		18,000	Stock	40,000
Creditors		12,000	Debtors	30,000
		80,000		80,000

On 31st December 2006 the trial balance is:

	Rs.	*Rs.*
Stock	40,000	
Furniture	3,000	
Investment	5,000	
Insurance Policy	2,000	
Business Purchase Account	80,000	
Bank Loan		18,000
Capital :		
Gupta		30,000
Singh		20,000
Raman		30,000
Bank	3,000	
Debtors	48,000	
Creditors		15,000

Purchases	3,20,000	
Expenses	12,000	
Sales		4,00,000
	5,13,000	5,13,000

Closing Stock Rs. 50,000

Solution

Business Purchase Account

2006	*Rs.*		*Rs.*
Dec. 31			
To Balance b/d	80,000	By Bank Loan	18,000
To Investments	5,000	By Gupta's Capital A/c	30,000
To Insurance Policy	2,000	By Singh's Capital A/c	20,000
		By Goodwill	6,000
		By Profit & Loss A/c (Balance figure, profit upto 31st March, 2006)	13,000
	87,000		87,000

Profit & Loss Account of Raman for the year ended 31st December, 2006

	Rs.		*Rs.*
To Opening Stock	40,000	By Sales	4,00,000
To Purchases	3,20,000	By Closing Stock	50,000
To Expenses	12,000		
To Business Purchase (Profit upto 31st March)	13,000		
To Net Profit Raman's Capital A/c	65,000		
	4,50,000		4,50,000

Balance Sheet of Raman as on 31st December, 2006

Liabilities		*Rs.*	*Assets*	*Rs.*
Raman's Capital A/c	30,000		Goodwill	6,000
Add : Profit	65,000	95,000	Furniture	3,000
Sundry Creditors		15,000	Stock in trade	50,000
			Sundry Debtors	48,000
			Cash at Bank	3,000
		1,10,000		1,10,000

Working Notes :

(1) *Goodwill*

		Rs.
Value of Assets taken over		
	Stock	46,000
	Debtors	35,000
	Furniture	3,000
		84,000
Less : Creditors		10,000
Net assets		74,000
Goodwill (Balancing figure)		6,000
Purchase Consideration		80,000

(2) *Increase in net assets upto 31st March 2006* :

	as on 1st January Rs.	*as on 31st March* Rs.
Debtors	30,000	35,000
Stock	40,000	46,000
Furniture	3,000	3,000
	73,000	84,000
Less : Creditors	12,000	10,000
	61,000	74,000
Profit, equal to net increase	13,000	–
	74,000	74,000

2.2 Conversion of Partnership Firm into a Company

At times partnerships also are reconstructed like joint stock companies, with the help of creditors if they are satisfied that if by taking of further risk or forgoing a part of the debt, the chances of recovery of their loan and capital would improve.

It usually entails preparation of Reconstruction Account for determining the past losses which belong to old partners and writing them off to the debit of their capital accounts. If a creditor agrees to join as a partner the whole or only a part of the account standing to the credit of his loan account is transferred to his capital account. For the further development of the business, usually some fresh capital/loan is required. The amount of loan is placed to the credit of the party contributing the same on such terms and conditions as may have been agreed upon.

Illustration 3

The following is the Balance Sheet of Messers A and B as on 31st March 2005 :

Liabilities		*Rs.*	*Assets*	*Rs.*
A's Capital	40,000		Land and Buildings	50,000
B's Capital	50,000	90,000	Stock	30,000
			Debtors	20,000
A's Loan		10,000	Investment	
General Reserve		10,000	6% Debentures in X Ltd.	20,000
Liabilities		20,000	Cash	10,000
		1,30,000		1,30,000

It was agreed that Mr. C is to be admitted for a fifth share in the future profits from 1st April 2005. He is required to contribute cash towards goodwill and Rs. 10,000 towards capital.

The following further information is furnished :

(i) The partners A and B shared the profits in the ratio 3:2.

(ii) Mr. A was receiving a salary of Rs. 500 p.m. from the very inception of the firm in 1988 in addition to share of profit.

(iii) The future profit ratio between A, B and C will be 3:1:1. Mr. A will not get any salary after the admission of Mr. C.

(iv) (a) The goodwill of the firm shall be determined on the basis of 2 years' purchase of the average profits from business of the last 5 years. The particulars of the profits are as under :

			Rs.
Year ended	31-3-01	Profit	20,000
Year ended	31-3-02	Loss	10,000
Year ended	31-3-03	Profit	20,000
Year ended	31-3-04	Profit	25,000
Year ended	31-3-05	Profit	30,000

The above profits and losses are after charging the salary of Mr. A. The profit of the year ended 31st March 2001 included an extraneous profit of Rs. 30,000 and the loss of the year ended 31st March 2002 was on account of loss by strike to the extent of Rs. 20,000.

(b) It was agreed that the value of the goodwill of the firm shall appear in the books of the firm.

(v) The trading profit for the year ended 31st March, 2006 was Rs. 40,000 before depreciation.

(vi) The partners had drawn each Rs. 1,000 p.m. as drawings.

(vii) The value of the other assets and liabilities as on 31st March, 2006 were as under :

	Rs.
Building (before depreciation)	60,000
Stock	40,000
Debtors	Nil
Investment	20,000
Liabilities	Nil

(viii) Provide depreciation at 5% on land and buildings on the closing balance and interest at 6% on A's loan.

(ix) They applied for conversion of the firm into a Private Limited Company. Certificate received on 1-4-2006. They decided to convert Capital A/cs of the partners into share capital in the ratio of 3 : 1 :1 on the basis of total Capital as on 31-3-2006. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the Profit and Loss Account for the year ended 31st March, 2006 and the Balance Sheet of the company.

Solution

Messrs A, B and C

Profit & Loss A/c for the year ending on 31st March, 2006

		Rs.		Rs.
To	Dep. Building	3,000	By Trading Profit	40,000
To	Interest on A's loan	600	By Interest on Debentures	1,200
To	Net Profit to :			
	A's Capital A/c	22,560		
	B's Capital A/c	7,520		
	C's Capital A/c	7,520		
		41,200		41,200

Balance Sheet of the Company as on 1-4-2006

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital	1,59,120	Goodwill	39,600
Loan from A	10,600	Land & Building	57,000
		Investments	20,000
		Stock in Trade	40,000
		Cash	13,120
	1,69,720		1,69,720

Working Notes :

1. Calculation of goodwill :

	Year ended March, 31				
	2001	2002	2003	2004	2005
	Rs.	*Rs.*	*Rs.*	*Rs.*	*Rs.*
Book Profits	20,000	– 10,000	20,000	25,000	30,000
Adjustment for extraneous profit 2001 and abnormal loss 2002	– 30,000	+ 20,000	—	—	—
	– 10,000	+ 10,000	20,000	25,000	30,000
Add Back: Remuneration of A	6,000	6,000	6,000	6,000	6,000
	– 4,000	16,000	26,000	31,000	36,000
Less : Debenture Interest being non-operating income*	1,200	1,200	1,200	1,200	1,200
	– 5,200	14,800	24,800	29,800	34,800
Total Profit from 2002 to 2005					1,04,200
Less : Loss for 2001					5,200
					99,000
Average Profit					19,800
Goodwill equal to 2 years' purchase					39,600
Contribution from C, equal to 1/5					7,920

2. Partners' Capital Accounts

	A	*B*	*C*		*A*	*B*	*C*
	Rs.	*Rs.*	*Rs.*		*Rs.*	*Rs.*	*Rs.*
To Drawings	12,000	12,000	12,000	By Balance b/d	40,000	50,000	—
To Balance c/d	80,320	65,360	13,440	By General Reserve	6,000	4,000	—
				By Goodwill	23,760	15,840	—
				By Bank	—	—	17,920
				By Profit & Loss A/c	22,560	7,520	7,520
	92,320	77,360	25,440		92,320	77,360	25,440

3. Balance Sheet as on 31st March, 2006

Liabilities	*Rs.*	*Rs.*	*Assets*	*Rs.*	*Rs.*
A's Capital		80,320	Goodwill		39,600*

B's Capital		65,360	Land & Building	60,000	
C's Capital		13,440	*Less* : Dep.	3,000	57,000
A's Loan	10,000		Investments		20,000
Add : Int. due	600	10,600	Stock-in-trade		40,000
			Cash (Balancing figure)		13,120**
		1,69,720			1,69,720

4. Conversion into Company

		Rs.
Capital :	A	80,320
	B	65,360
	C	13,440
Share Capital		1,59,120
Distribution of share :	A (3/5)	95,472
	B (1/5)	31,824
	C (1/5)	31,824

A should subscribe shares of Rs. 15,152 (Rs. 95,472 – Rs. 80,320) and C should subscribe shares of Rs. 18,384 (Rs. 31,824 – Rs. 13,440) B withdraws Rs. 33,536 (Rs. 65,360 – Rs. 31,824) subscribing to shares worth Rs. 31,824.

* It is shown in the books of the firm only to determine the closing capital of partners inclusive of goodwill before conversion.

** Also the closing cash balance can be derived as shown below :

	Rs.	*Rs.*
Trading profit (assume realised)		40,000
Add: Debenture Interest		1,200
Add: Decrease in Debtors Balance		20,000
		61,200
Less: Increase in stock	10,000	
Less: Decrease in Liabilities	20,000	30,000
Cash Profit		31,200
Add: Opening cash balance		10,000

Add: Cash brought in by C		17,920
		59,120
Less: Drawings	36,000	
Less: Additions to Building	10,000	46,000
		13,120

2.2.1 Apportionment of shares amongst the partners : Sometime an examination problem may require the students to suggest equitable basis for division of shares between the vendors, when they are partners, so as to preserve the rights as previously existed between them, that is, to maintain the same profit-sharing ratio and to preserve the priority in regard to repayment of capital.

Suppose A, B and C share profits and losses in the ratio 3 : 2 : 1 after allowing interest on capital @ 9% p.a. Their capitals on 31st December, 2005 were: A Rs. 50,000, B Rs. 30,000 and C Rs. 20,000. On 1st January, 2006 the business was converted into a limited company and was valued at Rs. 1,30,000. A scheme of capitalisation, whereby the mutual interest of partners may remain intact as far as possible is suggested below:

The total capital being Rs. 1,00,000 and the value placed on the business being Rs. 1,30,000 there is goodwill of Rs. 30,000 to be shared by the partners in the ratio of 3: 2:1 or A Rs. 15,000, B Rs. 10,000 and C Rs. 5,000. The capital will now be: A Rs. 65,000, B Rs. 40,000 and C Rs. 25,000.

Taking B's capital as the basis, A's capital should be Rs. 60,000, *i.e.* 40,000 × 3/2 and C's capital should be Rs. 20,000. Both A and C have Rs. 5,000 excess. Since interest on capital is meant to compensate those whose capital is in excess of proportionate limits and since in the case of partners it is an appropriation of profit, it will be proper to give 9% preference shares to A & C for Rs. 5,000 each and the remaining amount of Rs. 1,20,000 can be in the form of equity shares to be divided among A, B and C in the ratio of 3 : 2 : 1. They will then share the company's profit in the ratio of 3 : 2 : 1 after allowing preference dividend.

Self-Examination Questions

I. Objective type questions

Choose the most appropriate answer from the given options:

1. The assets , liabilities and capital accounts of the amlgamaing partnership firm are

closed by opening

- (a) Realization account.
- (b) Revaluation account.
- (c) New firm's account.
- (d) None of the above.

2. In case of amalgamation, profit/ loss on sale of the firm is ascertained by
   - (a) Realization account.
   - (b) Revaluation account.
   - (c) New firm's account.
   - (d) Profit and loss adjustment account.
3. Liabilities not taken over by the new firm (at the time of amalgamation) will be transferred to
   - (a) Capital accounts.
   - (b) Revaluation account.
   - (c) New firm's account.
   - (d) Profit and loss adjustment account

[**Answers : 1.** (c); **2.** (a); **3.** (a)]

II. Short answer type questions

4. Describe the accounting procedure in brief when two partnership firm are amalgamated to form a new firm.

III. Long answer type questions

5. What do you mean by amalgamation of firms? What entries are passed to close the books of the firms which are amalgamated?
6. How will you treat assets and liabilities not taken over by the new firm in the books of the amalgamated firm?

IV. Practical problems

7. Mr. B and Mr. E are partners sharing Profits and Losses in the ratio of 3:2. On 30th September, 2005 they admit Mr. C as a partner, and the new profit ratio is 2:2:1. C brought in Fixtures Rs. 3,000 and cash Rs. 10,000, the goodwill being (i) B and E Rs. 20,000 and (ii) C Rs. 10,000 but neither figure is to be brought into the books.

   On 31st March, 2006, the partnership is dissolved, B retiring and the other two partners forming a company called BC Limited with equal capitals, taking over all remaining assets and liabilities, goodwill being agreed at Rs. 40,000 and brought into books of the company. B agrees to take over the business car at Rs. 3,700: Plant was sold for Rs. 3,000 being in excess of requirements. The profit of the two preceding years were Rs. 17,200 and Rs. 19,000 respectively and it was agreed that for the half year ended 30th September, 2005 the net profit was to be taken as equal to the average of the two preceding years and the current year.

   No entries has been made when C entered, except cash. No new book being opened by BC Company Ltd., B agreed to have Rs. 50,000 as loan to the company, secured by 12% Debentures. The following is the Trial Balance as on 31st March, 2006.

	Debit	*Credit*
	Rs.	Rs.
Capital Accounts:		
B		35,000
E		20,000
C		10,000
Drawing Accounts:		
B	6,000	
E	5,000	
C	2,800	
Debtors & Creditors	31,000	12,000
Plant (Book value of plant sold Rs. 4,000)	23,000	
Fixtures	7,000	

Motor Car	2,700	
Stock on 31st March, 2006	13,000	
Bank	16,300	
P & L A/c for the year		29,800
	1,06,800	1,06,800

Prepare :

- (1) Goodwill Adjustment Account
- (2) Capital Accounts of Partner
- (3) Profit and Loss Appropriation Account
- (4) Balance Sheet of BC Ltd. as on 31st March,2006.

8. Ram, Rahim and Robert are partners of the firm 'RR Traders' for the past 5 years. The partners decided to dissolve the firm consequent to insolvency of partner Robert in October, 2005. The Balance Sheet of the firm as on 31.10.2005 is furnished below. They share profits and losses equally:

Liabilities		*Rs.*	*Assets*	*Rs.*
Capital Accounts:			Land and Building	5,00,000
	Ram	4,50,000	Plant and Machinery	2,00,000
	Rahim	4,50,000	Furniture and Fittings	50,000
	Robert	2,00,000	Stock in Trade	3,00,000
General Reserve		2,10,000	Debtors	5,00,000
Creditors		2,90,000	Cash at Hand/Bank	50,000
		16,00,000		16,00,000

The partners Ram and Rahim decided to form a new firm 'RR Enterprises' and takeover all the assets and liabilities of the firm at values given below:

Land and Building	Rs. 3,50,000
Plant and Machinery	Rs. 1,50,000
Furniture and Fittings	Rs. 20,000

Stock in trade Rs. 2,00,000

Debtors include Rs. 3,00,000 due from SK & Co. owned by Robert. (Nothing is recoverable from the said concern).

Other debtors can be recovered fully.

Prepare:

- (i) Realisation account, Partners' capital accounts in the books of RR Traders; and
- (ii) The Balance Sheet of RR Enterprises (immediately after commencement).

CHAPTER 4

COMPANY ACCOUNTS

UNIT – 1

Learning Objectives

After studying this unit, you will be able to

- Learn the provisions of the Companies Act regarding employees' stock option.
- Understand the accounting policies of employees' stock option plan.
- Learn the accounting treatment of employees' stock options.
- Learn the provisions of Guidance Note on Employee share-based Payments.
- Learn the provisions of the Companies Act regarding buyback of securities
- Understand equity shares with differential rights.

1.1. EMPLOYEES STOCK OPTION PLAN

The Companies (Amendment) Act 2000 has inserted a new clause (15A) in section 2 of the Companies Act, 1956, which states that "employee stock option" means the option given to the whole-time directors, officers or employees of a company, which gives such directors, officers or employees the benefit or right to purchase or subscribe at a future date, the securities offered by the company at a pre-determined price.

Securities and Exchange Board of India issued Employees Stock Option Scheme and Employee Stock Purchase Scheme Guidelines in 1999 under section 11 of the Securities and Exchange Board of India Act, 1992.

Accounting for employees stock option plan (ESOPs): Before proceeding on accounting treatment of ESOPs, certain words are necessary to be defined which will be covered later on in the context of accounting entries.

Grant : Grant of the option means giving an option to the employees to subscribe to the shares of the company.

Vesting : It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in purchase of employee in pursuance of ESOS.

Vesting Period : It is the time period during which the vesting of the option granted to the employee on pursuance of employee stock option scheme (ESOS) takes place.

Option : Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.

ACCOUNTING POLICIES OF ESOS :

(a) In respect of options granted during any accounting period the accounting value of the options shall be treated as another form of employee compensation in the financial statements of the company.

(b) The accounting value of options shall be equal to the aggregate, over all employee stock options granted during the accounting period, of the fair value of the option.

1. Fair value means the option discount, or, if the company so chooses, the value of the option using the Black Scholes formula or other similar valuation method.

2. Option discount means the excess of the market price of the share at the date of grant of the option under ESOS over the exercise price of the option (including up-front payment, if any).

(*c*) Where the accounting value is accounting for employee compensation in accordance with 'b', the amount shall be amortised on a straight-line basis over the vesting period.

(*d*) When an unvested option lapses by virtue of the employee not confirming to the vesting conditions after the accounting value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense equal to the amortized portion of accounting value of the accounting value of the lapsed options and a credit to deferred employee compensation expense equal to the unamortized portion.

(*e*) When a vested option lapses on expiry of the exercise period, after the fair value of the option has already been accounted for as employee compensation, this accounting treatment shall be reversed by a credit to employee compensation expense.

(*f*) The accounting treatment specified above can be illustrated by the following numerical example :–

DISCLOSURE IN THE DIRECTORS' REPORT

The Board or Directors, shall, inter alia, disclose either in the Directors Report or in the annexure to the Director's Report, the following details of the ESOS :

(a) options granted;

(b) the pricing formula;

(c) options vested;

(d) options exercised;

(e) the total number of shares arising as a result of exercise of option;

(f) options lapsed;

(g) variation of terms of options;

(h) money realised by exercise of options;

(i) employee wise details of options granted to;

 (i) senior managerial personnel;

 (ii) any other employee who receives a grant in any one year of option amounting to 5% or more of option granted during that year;

 (iii) Identined employees who were granted option, among any during the year, equal to or exceeding 1% of the issued capital (excluding outstanding warrants and conversions) of the company at the time of grant;

(j) diluted Earnings Per Share (EPS) pursuant to issue of shares on exercise of option calculated in accordance with International Accounting Standard (IAS) 33.

PROVISIONS OF GUIDANCE NOTE ON EMPLOYEE SHARE-BASED PAYMENTS

Recognizing the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An enterprise should recognize as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted (subject to the requirements of paragraphs 9 to 11). If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognized for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or right to exercise) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognized in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements.

Illustration 1

A Company has its share capital divided into shares of Rs. 10 each. On 1st April, 2007 it granted 10,000 employees' stock options at Rs. 40, when the market price was Rs. 130. The options were to be exercised between 16th December, 2007 and 15th March, 2008. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

JOURNAL ENTRIES

	Particulars		Dr.	Cr.
			Rs.	Rs.
2007				
April 1	Employee Compensation Expense	Dr.	9,00,000	
	To Employee Stock Options Outstanding			9,00,000
	(Being grant of 10,000 stock options to employees at Rs. 40 when market price is Rs. 130)			

2008				
16th Dec. to 15th March	Bank	Dr.	3,80,000	
	Employee stock options outstanding	Dr.	8,55,000	
	To Equity share capital			95,000
	To Securities premium			11,40,000
	(Being allotment to employees of 9,500 equity shares of Rs. 10 each at a premium of Rs. 120 per share in exercise of stock options by employees)			
March 16	Employee stock options outstanding	Dr.	45,000	
	To Employee compensation expense			45,000
	(Being entry for lapse of stock options for 500 shares)			
March 31	Profit and Loss A/c	Dr.	8,55,000	
	To Employee compensation expense			8,55,000
	(Being transfer of employee compensation expense to profit and loss account)			

Employee Stock Options Outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Equity.

Illustration 2

ABC Ltd. grants 1,000 employees stock options on 1.4.2004 at Rs.40, when the market price is Rs.160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2006. 600 options are exercised on 30.6.2007. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

Solution

In the Books of ABC Ltd.
Journal Entries

Date	Particulars		Dr. (Rs.)	Cr. (Rs.)
31.3.2005	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years - 1,000 stock options x Rs. 48)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.2006	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expense recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of Rs. 120 each, amortised on straight line basis over $2\frac{1}{2}$ years - 1,000 stock options x Rs. 48)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			

31.3.2007	Employee stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2007	Bank A/c (600XRs.40)	Dr.	24,000	
	Employee stock option outstanding account (600XRs.120)	Dr.	72,000	
	To Equity share capital account (600XRs. 10)			6,000
	To Securities premium account (600XRs.150)			90,000
	(Being 600 employee stock option exercised at an exercise price of Rs. 40 each)			
01.10.2007	Employee stock option outstanding account	Dr.	12,000	
	To General reserve account			12,000
	(Being ESOS outstanding A/c on lapse of 100 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:

At 31.3.2007, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that actually vested. Considering that 700 stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

No. of options actually vested (700 x 120)	Rs.84,000
Less: Expenses recognized Rs.(48,000 + 48,000)	Rs. 96,000
Excess expenses transferred to general reserve	Rs.12,000

Illustration 3

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2005 for Rs.20, depending upon the employees at the time of vesting of options. The market price of the share is Rs.50. These options will vest at the end of year 1 if the earning of Choice Ltd. increases 16%, or it will vest at the end of the year 2 if the average earning of two years increases by 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will increase by 10%. 5,000 unvested options lapsed on 31.3.2006. 4,000 unvested options lapsed on 31.3.2007 and finally 3,500 unvested options lapsed on 31.3.2008.

Following is the earning of Choice Ltd. :

Year ended on	Earning (in %)
31.3.2006	14%
31.3.2007	10%
31.3.2008	7%

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

Solution

Date	Particulars		Rs.	Rs.
31.3.2006	Employees compensation expenses A/c	Dr.	14,25,000	
	To ESOS outstanding A/c			14,25,000
	(Being compensation expense recognized in respect of the ESOP i.e. 100 options each granted to 1,000 employees at a discount of Rs. 30 each, amortised on straight line basis over vesting years- Refer W.N.)			
31.3.2007	Employees compensation expenses A/c	Dr.	3,95,000	
	To ESOS outstanding A/c			3,95,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
30.3.2008	Employees compensation Expenses A/c	Dr.	8,05,000	
	To ESOS outstanding A/c			8,05,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			

30.3.2008	Bank A/c (85,000 X Rs.20)	Dr.	17,00,000	
	ESOS outstanding A/c [(26,25,000/87,500) x 85,000]	Dr.	25,50,000	
	To Equity share capital (85,000 x 10)			8,50,000
	To Securities premium A/c (85,000 X Rs.40)			34,00,000
	(Being 85,000 options exercised at an exercise price of Rs. 50 each)			
	ESOS outstanding A/c	Dr.	75,000	
	To General Reserve A/c			75,000
	(Being ESOS outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:

Statement showing compensation expenses to be recognized

Particulars	Year 1 (31.3.2006)	Year 2 (31.3.2007)	Year 3 (31.3.2008)
Length of the expected vesting period (at the end of the year)	2nd year	3rd year	3rd year
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expense accrued (50-20)	Rs. 28,50,000	Rs. 27,30,000	Rs. 26,25,000
Compensation expense of the year	28,50,000 x 1/2 = Rs.14,25,000	27,30,000 x 2/3 = Rs.18,20,000	Rs. 26,25,000
Compensation expense recognized previously	Nil	Rs.14,25,000	Rs. 18,20,000
Compensation expenses to be recognized for the year	Rs.14,25,000	Rs. 3,95,000	Rs. 8,05,000

1.2 BUY BACK OF SECURITIES

The Companies (Amendment) Act, 1999 has introduced Section 77A in the Companies Act, 1956, permitting companies to buyback their own shares and other securities. A company may now, purchase its own shares or other specified securities out of -

(*i*) its free reserves; or

(*ii*) the securities premium account; or

(*iii*) the proceeds of any shares or other specified securities.

Provided that no buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are :

(1) No company shall purchase its own shares or other specified securities unless—

- (*a*) the buy-back is authorised by its articles;
- (*b*) a special resolution has been passed in general meeting of the company authorising the buy-back;
- (*c*) the buy-back is of less than twenty-five per cent of the total paid-up capital and free reserves of the company:

  Provided that the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year.
- (*d*) the ratio of the debt owned by the company is not more than twice the capital and its free reserves after such buy-back:

  Provided that the Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies.

  Explanation.—For the purposes of this clause, the expression "debt" includes all amounts of unsecured and secured debts;
- (*e*) all the shares or other specified securities for buy-back are fully paid-up;
- (*f*) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;
- (*g*) the buy-back in respect of shares or other specified securities other than those specified in clause (*f*) is in accordance with the guidelines as may be prescribed.

(2) Every buy-back shall be completed within twelve months from the date of passing the special resolution.

(3) The buy-back may be—

(*a*) from the existing security holders on a proportionate basis; or

(*b*) from the open market; or

(*c*) from odd lots, that is to say, where the lot of securities of a public company, whose shares are listed on a recognised stock exchange, is smaller than such marketable lot, as may be specified by the stock exchange; or

(*d*) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(4) Where a company has passed a special resolution under clause (*b*) of Sub-section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any :

Provided that no declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(5) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

(6) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (*a*) of Sub-section (1) of Section (81) or other specified securities within a period of twenty-four months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

Explanation.—For the purposes of this section,—

(*a*) "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time;

(*b*) "free reserves" shall have the meaning assigned to it in clause (*b*) *Explanation to Section 372A.* [As per this explanation, "free reserves" means those reserves which, as per latest audited balance-sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money.]

According to Section 77AA, where a company purchases its own shares out of free reserves, then a sum equal to the nominal value of the share so purchased shall be transferred to the capital redemption reserve account referred to in clause (*d*) of the proviso to sub-section (1) of Section 80 and details of such transfer shall be disclosed in the balance sheet.

1.2.1 PROVISIONS OF SECTION 77B OF COMPANIES ACT

As per Section 77B :

(1) No company shall directly or indirectly purchase its own shares or other specified securities—

(*a*) through any subsidiary company including its own subsidiary companies; or

(*b*) through any investment company or group of investment companies; or

(*c*) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting.

(2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 159, 207 and 211.

Illustration 4

Anu Ltd. furnishes you with the following balance sheet as at 31st March, 2008:

(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
Application of Funds		
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 1st April, 2008. It also bought back 50 lakh equity shares of Rs.10 each at Rs.50 per 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 as at 1.4.2008

Solution

Journal entries in the books of Anu Ltd.

Rs. in crores

	Particulars		Debit	Credit
1st April, 2008	12% Preference share capital A/c	Dr.	75	
	To Preference shareholders A/c			75
	(Being preference share capital account transferred to shareholders account)			

Preference shareholders A/c	Dr.	75	
To Bank A/c			75
(Being payment made to shareholders)			
Shares buy back A/c	Dr.	25	
To Bank A/c			25
(Being 50 lakhs equity shares bought back @ Rs.50 per share)			
Equity share capital A/c (50 Lakhs x Rs.10)	Dr.	5	
Securities premium A/c (50 Lakhs x Rs.40)	Dr.	20	
To Shares buy back A/c			25
(Being cancellation of shares bought back)			
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)			

(ii) Balance sheet of Anu Ltd as at 1.4.2008

Liabilities		*(Rs. in crores)*	*Assets*		*(Rs. in crores)*
Share Capital:			Fixed assets:		
Authorised		100	Cost	100	
Issued, subscribed and paid up:			*Less*: Provision for depreciation	(100)	Nil
200 lakhs equity shares of Rs.10 each		20	Investment at cost (Market value Rs.400 crores)		100
Reserves and surplus:					
Capital reserve	15		Current assets as on 31.3.2008	340	
Capital redemption reserve	80		*Less*: Bank payment for redemption and buy back	(100)	240
Securities premium (25-20)	5				

Revenue reserve (260-80)	180	280	
Current liabilities		40	
		340	340

1.3 EQUITY SHARES WITH DIFFERENTIAL RIGHTS

The Companies Amendment Act, 2000 has allowed companies to issue equity shares with disproportionate rights. The Companies Amendment Act, 2000 has deleted Section 88 of the Companies Act 1956 which prohibited issuance of equity shares with disproportionate rights as to voting, dividend, capital or otherwise. Section 86 of the Companies Act has been amended by the Amendment Act, 2000 which can be reproduced as follows :

Section 86 : New issues of share capital to be only of two kinds – the share capital of a company limited by shares shall be only two kinds only, namely :–

(a) equity share capital –

- (i) with voting rights; or
- (ii) with differential rights as to dividend, voting or otherwise in accordance with such rules and subject to such conditions as may be prescribed.

(b) preference share capital.

Self-Examination Questions

I. Objective type questions

Choose the most appropriate answer from the given options.

1. Vesting period is the period between the ___________date and the date on which all the specified vesting conditions of an employee share based payment plan are to be satisfied.
   - (a) Issue.
   - (b) Grant.
   - (c) Either (a) or (b) whichever is earlier.
2. The balance of stock option outstanding account will appear
   - (a) On the assets side of the balance sheet.

(b) Under the head "reserves and surplus" on the liabilities side of the balance sheet.

(c) After the head "share capital" but before the head "reserves and surplus" on the liabilities side of the balance sheet.

3. Fair value of stock options granted should be measured at

(a) Cost price of stock options.

(b) market prices considering the terms and conditions upon which those stock options were granted.

(c) None of the above.

4. A company may purchase its own shares or other specified securities out of

(a) Free reserves.

(b) Securities premium account.

(c) Both (a) and (b).

5. Buy-back of equity shares in any financial year shall not exceed ____________per cent of its total paid-up equity capital in that financial year.

(a) 20.

(b) 25.

(c) 30.

6. No company shall purchase its own shares or other specified securities unless the ratio of the debt owned by the company is not ___________ the capital and its free reserves after such buy-back:

(a) Less than twice.

(b) More than twice.

(c) More than thrice.

7. The buy-back may be from the

(*a*) Existing security holders on a proportionate basis.

(*b*) Open market.

(c) Either (a) or (b).

[**Answer** **1.** (a), **2.** (c), **3.** (b),**4.** (c), **5.** (b), **6.** (b), **7.** (c)]

II. Short Answer Type Questions

8. What is the objective and importance of employee stock options?

9. Define the following terms:

   (a) Vesting period.

   (b) Employees' stock option plan.

   (c) Grant date.

10. How should fair value of stock options granted be measured if market prices are not available?

11. How will you disclose employee compensation expense in profit and loss account of an enterprise?

12 What is meant by buy back of securities?" Describe in brief.

13. Can the company buy back its shares out of free reserves? Explain.

III. Long Answer Type Questions

14. What are the factors to be taken into account while estimating the fair value of the shares?

15. What should be the consideration for shares issued by the enterprise on exercise of the right to obtain stock options?

16. Explain the provisions of Section 77 B of the Companies Act regarding buy back of securities.

IV. Practical Problems

17. A Company has its share capital divided into shares of Rs. 100 each. On 1st April, 2006 it granted 1,000 employees' stock options at Rs. 50, when the market price was Rs. 100. The options were to be exercised between 16th December, 2006 and 15th March, 2007. The employees exercised their options for 900 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

18. ABC Ltd. resolved to buy back 3,00,000 of its fully paid equity shares of Rs. 10 each at Rs. 12 per share. For the purpose , it issued 10,000 13% preference shares of Rs. 100 each at par, the total sum being payable with applications. The company uses Rs. 8,50,000 of its balance in securities premium account apart from its adequate balance in general reserve account to fulfil the legal requirements regarding buy-back. Pass the necessary journal entries.

UNIT – 2 : UNDERWRITING OF SHARES AND DEBENTURES

Learning Objectives

After studying this unit, you will be able to

- Learn the provisions of the Companies Act regarding underwriting of shares
- Determine the liability of underwriters whether shares are fully underwritten or partially underwritten
- Account for firm underwriting of shares.

2.1 INTRODUCTION

Underwriting an issue of shares or debentures involves entering into a contract with a person known as underwriter, who may be an individual, partnership or company, undertaking that in the event of the shares or debentures not being subscribed by the public or only a part of them being subscribed, he shall take up the balance. In view of the magnitude of such an obligation, issues of shares or debentures are rarely underwritten by one person. They are either underwritten by two or more persons jointly or only a part of the issue is underwritten and, in respect of rest, the company takes the risk of the capital being not subscribed by the public.

In consideration of such a service, the underwriter is paid a commission. Section 76 of the Companies Act places certain restrictions on the rate of commission and the conditions under which it can be paid. It provides that commission only at a rate authorized by the Articles, not exceeding 2½% of the issue price of debentures and 5% of shares, can be paid. No commission can be paid in respect of shares or debentures which have not been offered to the general public for subscription.

The function of an underwriter has great economic significance. It provides an assurance to the company that it would be able to raise the stipulated amount of capital by the issue of shares or debentures and, on the basis of such an assurance; it can proceed to draw up its investment programme. The Central Government has recently set up a number of financial institutions for helping companies to raise capital. One of the forms in which such a help is rendered is by underwriting the issues of shares and debentures, made by the companies. The prominent institutions that render this service are: Industrial Finance Corporation, Industrial Credit and Investment Corporation of India and Life Insurance Corporation of India.

2.2 PROVISIONS IN THE COMPANIES ACT AFFECTING UNDERWRITING

Disclosure in the Prospectus - According the Companies Act, it is necessary that when any issue of shares or debentures is underwritten, the names of the underwriters and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations should be stated.

Disclosure in the Statutory Report - According to clause (6) of the Form prescribed for such a report, a brief description of each underwritten contract should be given and, if any contract has not been carried out fully, the extent to which it has not been carried out and reasons therefore should be stated. In addition, particulars of any commission paid or payable to any Director, Manager, or their associates should be disclosed.

2.3 DETERMINATION OF LIABILITY IN RESPECT OF AN UNDERWRITING CONTRACT

If the whole of the issue has been underwritten by one person, he is responsible to subscribe for all the shares or debentures that have not been subscribed by the public. In such a case, it is not necessary to know the number of applications which had originated through the underwriter and those which had flowed directly to the company.

In the case in which only part of an issue has been underwritten, or where there are a number of underwriters, a certain amount of difficulty may arise in determining the liability of each of the underwriters; such a difficulty may arise in deciding the basis on which the unmarked applications, *i.e.* the applications which have directly flowed to the company should be allocated among the different underwriters.

This can be done in two ways. According to one method, the unmarked applications are allotted in the proportion of gross amount of capital underwritten. Alternatively these are allocated in proportion to the gross amount of capital underwritten as reduced by the marked applications. How by following one or the other method, the liability of the underwriter or writers is ascertained is explained below.

Illustration 1

Elahi Buksh & Co. Ltd. issued 10,000 equity shares. These were underwritten as follows:

A	40%	B	35%	C	25%

In all, applications for 8,000 shares were received; applications for 2,000 shares have the stamp of A; those for 1,000 shares that of B, and those for 2,000 shares that of C. There were thus applications for 3,000 shares which did not bear any stamp. If credit for unmarked applications is given to A, B and C in proportion to their gross liability, the liability of each of the underwriters will be as shown below:

	A	B	C
Gross liability	4,000	3,500	2,500
Less: Unmarked applications			
3,000 shares in the ratio of 40:35:25	1,200	1,050	750

2,800	2,450	1,750	
Marked applications	2,000	1,000	2,000
Balance	800	1,450	—250
Credit to A and B for C's surplus (ratio 40:35)	133	117	—250
Actual liability	667	1,333	—

If however, the other view is taken that unmarked applications should be credited to different underwriters in the ratio of liability after credit for marked applications has been given - the position will be as follows :

	A	B	C
Gross liability	4,000	3,500	2,500
Less: Unmarked applications	2,000	1,000	2,000
	2,000	2,500	500
Less: Unmarked applications	1,200	1,500	300
(Shares in ratio of 20:25:5)			
Net liability	800	1,000	200

The liability in this case could also be determined by simply apportioning the total number of shares yet to be subscribed (2,000 in the above case) in the proportion of the balance of the liability after credit for marked forms has been given. Since the liability of each underwriter may vary widely if one or the other method is followed, the underwriting contract should specify the method to be followed (in the examination the position should be clarified by way of a note).

2.4 DETERMINATION OF LIABILITY WHERE ONLY PART OF THE ISSUE HAS BEEN UNDERWRITTEN

In such a case the company is treated as having underwritten the balance of shares which have not been underwritten. In this assumption, the unmarked applications are treated as marked so far as the company is concerned. Suppose, a company has issued 10,000 shares of which only 6,000 have been underwritten by X; marked applications exceed 6,000. In such a case, X would not be liable to subscribe for any shares. If, however, there are marked applications for only 5,000 shares X would have to subscribe for 1,000 shares provided on his doing so the total number of shares allotted (including those to X) does not exceed 10,000. If it does, the number of shares which X must subscribe will be reduced to that extent.

In case the information as regards the number of applications that are marked and those that are unmarked is not available (for instance, in an examination) it should be assumed that out of the total number of applications received a number proportionate to the value of the issue underwritten has been received through the underwriters. For example, if according to the facts given above, total applications received are for 8,000 shares it should be assumed that 60% (the proportion of the total number of shares underwritten) are through X. In that case, X would be liable to subscribe 60% of 2,000 shares—the total number of shares not subscribed by public.

The surplus shown by the particular underwriters is to be credited to the other underwriters in same proportion as for unmarked applications.

Illustration 2

Newton Limited incorporated on 1st January, 2008 issued a prospectus inviting applications for 20,000 equity shares of Rs. 10 each. The whole issue was fully underwritten by Adams, Benzamin and Clayton as follows:

Adams	10,000 shares
Benzamin	6,000 shares
Clayton	4,000 shares

Applications were received for 16,000 shares, of which marked applications were as follows:

Adams	8,000 shares
Benzamin	2,850 shares
Clayton	4,150 shares

You are required to find out the liabilities of individual underwriters.

Solution:

Statement of Net Liability of Underwriters

	Gross liability	Marked appli-cations	Number of Unmarked applications in the ratio of gross liability	Shares Total (2) + (3)	Surplus of Clayton in the ratio of 10:6	Total (4)+(5)	Net liability (1)- 6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Adams	10,000	8,000	500	8,500	219	8,719	1,281
Benzamin	6,000	2,850	300	3,150	131	3,281	2,719

Clayton	4,000	4,150	200	4,350	-350	4,000	–
	20,000	15,000	1,000	16,000	–	16,000	4,000

Note: The applications are for 16,000 shares out of which 15,000 are marked. Hence unmarked applications are for 1,000 shares.

2.5 FIRM UNDERWRITING

It signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public. In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him that is to say, the underwriter is obliged to take up :

(*i*) The number of shares he has applied for 'firm'; and

(*ii*) The number of shares he is obliged to take up on the basis of the underwriting agreement.

Suppose A underwrites 60% of an issue of 10,000 shares and besides applies for 1,000 shares, 'firm'. In case there are marked applications for 4,800 shares he will have to take 2,200 shares, *i.e.* 1,000 shares for which he applied 'firm' and 1,200 shares to meet his liability of underwriting contract. If, on the other hand, the underwriting contract has provided that abatement would be allowed in respect of shares taken up 'firm' the liability of A in the above-mentioned case would only be for 1,200 shares in total.

Illustration 3

Rosy Ltd. made a public issue of 4,00,000 equity shares of Rs. 10 each, Rs. 2 payable on application. The entire issue was underwritten by five underwriters as follows: A : 25%, B : 25%, C : 25%, D: 10% and E: 15%. Under the underwriting terms, a commission of 2% was payable on the amount underwritten. Further, the underwriter was at liberty to apply, during the tenure of public issue, for any number of shares in which case he was entitled to a brokerage equal to 1/2% of the par value of shares so applied for.

Applications received were to be analyzed on the basis of rubber stamp of the underwriter, who was to be given credit for the number of applications received bearing his rubber stamp. Applications received which did not bear any rubber stamp were considered as "direct applications" to be credited to all the underwriters in the ratio of their respective underwriting commitment. If, any such credits being given a "surplus" was to result in respect of any underwriter, as compared to his commitment, such surplus was to be distributed amongst the remaining underwriters in the ratio of their respective underwriting commitments.

As a result of the issue the following applications were received:

Bearing rubber stamp of	A	1,02,000 shares

-Do-	B	95,000 shares
-Do-	C	60,000 shares
-Do-	D	32,000 shares
-Do-	E	51,000 shares
Not bearing any stamp		10,000 shares
		3,50,000 shares

Included in the number of applications mentioned against D in the above table was an application made by D himself for 10,000 shares. The underwriters were informed of the amounts due to or from them, the amounts were duly received or paid.

Show, with the aid of necessary workings, the entries to record the amount so received or paid.

Solution

Workings For description of the columns see below :

Name	1	2	3	4	5	6	7	8	9	10	11	12
A.	1,00,000	1,02,000	2,500	1,04,500	–4,500	1,00,000	—	—	20,000	—	—	20,000
B.	1,00,000	95,000	2,500	97,500	1,500	99,000	1,000	2,000	20,000	—	—	18,000
C.	1,00,000	60,000	2,500	62,500	1,500	64,000	36,000	72,000	20,000	—	52,000	—
D.	40,000	32,000	1,000	33,000	600	33,600	6,400	12,800	8,000	500	4,300	—
E.	60,000	51,000	1,500	52,500	900	53,400	6,600	13,200	12,000	—	1,200	—
	4,00,000	3,40,000	10,000	3,50,000	—	3,50,000	50,000	1,00,000	80,000	500	57,500	38,000

Column No.

(1) Commitment—No. of Shares

(2) Marked Applications

(3) Additional proportionate no. of direct applications

(4) Total (2) + (3)

(5) Allocation of surplus

(6) Total (4)+(5)

(7) Final Deficit (1)—(6)

(8) Amount Receivable due @ Rs. 2 per share.

(9) Underwriting Commission due @ 2 % nominal value.

(10) Brokerage due @ 1/2%.

(11) Due from underwriters.

(12) Due to underwriters.

Journal Entry

		Dr.	Cr.
		Rs.	Rs.
Bank A/c	Dr.	57,500	
Underwriting Commission A/c	Dr.	80,000	
Brokerage on Shares A/c	Dr.	500	
To Equity Shares Applications A/c			1, 00,000
To Bank A/c			38,000

Illustration 4

Libra Ltd. came up with an issue of 20,00,000 equity shares of Rs. 10 each at par. 5,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters Anand, Vijay and Ashok - equally with firm underwriting of 50,000 shares each. Subscriptions totalled 12,97,000 shares including the marked forms which were :

Anand	4,25,000 shares
Vijay	4,50,000 shares
Ashok	3,50,000 shares

The underwriters had applied for the number of shares covered by firm underwriting. The amounts payable on application and allotment were Rs. 2.50 and Rs. 2.00 respectively. The agreed commission was 5%.

Pass summary journal entries for —

(a) The allotment of shares to the underwriters;

(b) The commission due to each of them; and

(c) The net cash paid and or received.

Note: Unmarked applications are to be credited to underwriters equally.

Solution: **Libra Ltd.**

Journal

		Dr. Rs.	Cr. Rs.
Bank A/c	Dr.	3,75,000	
To Share Application A/c			3,75,000
(Application money received on firm applications for 50,000 each @ Rs. 2.50 per share from Anand, Vijay & Ashok)			
Anand	Dr.	1,00,000	
Vijay	Dr.	1,00,000	
Ashok	Dr.	3,38,500	
Share Application A/c	Dr.	3,75,000	
To Share Capital A/c			9,13,500
(Allotment of shares to underwriters 50,000 to Anand; 50,000 to Vijay and 1,03,000 to Ashok; application and allotment money credited to share capital)			
Underwriting Commission A/c	Dr.	7,50,000	
To Anand			2,50,000
To Vijay			2,50,000
To Ashok			2,50,000
(Amount of underwriting commission payable to Anand, Vijay and Ashok @ 5% on the amount of shares underwritten.)			
Bank A/c	Dr.	88,500	
To Ashok			88,500
(Amount received from Ashok on shares allotted less underwriting commission)			

Anand	Dr.	1,50,000	
Vijay	Dr.	1,50,000	
To Bank A/c			3,00,000
(Amount paid to Anand & Vijay in final settlement of underwriting commission due less amount payable on shares allotted payable to him.)			

Working Notes :

(1) Calculation of Laibility of Underwriters

	Anand	Vijay	Ashok
Gross Liability (No. of shares)	5,00,000	5,00,000	5,00,000
Less : Firm Underwriting	50,000	50,000	50,000
	4,50,000	4,50,000	4,50,000
Less : Marked Applications	4,25,000	4,50,000	3,50,000
	25,000	—	1,00,000
Less : Unmarked Applications (equally)	36,000	—	36,000
	11,000	—	64,000
Less : Adjustment of Anand's surplus	(11,000)	—	11,000
Net liability, excluding firm underwriting	—	—	53,000
Firm underwriting	50,000	50,000	50,000
Gross liability	50,000	50,000	1,03,000

(2) Calculation of Amounts Payable by Underwriters

	Anand	Vijay	Ashok
liability (No. of shares)	50,000	50,000	1,03,000
	Rs.	Rs.	Rs.
Amount payable @ Rs. 4.50 per share	2,25,000	2,25,000	4,63,500
Less : Amount paid on Firm Applications of 50,000 each @ Rs. 2.50	1,25,000	1,25,000	1,25,000
Balance payable	1,00,000	1,00,000	3,38,500
Underwriting Commission Receivable	2,50,000	2,50,000	2,50,000
Amount Paid	1,50,000	1,50,000	—
Amount received by the Co.	—	—	88,500

Benefit of unmarked applications has not been given to Vijay as has surplus would have ultimately been credited for Anand & Ashok.

Illustration 5

A company made a public issue of 1, 25,000 equity shares of Rs. 100 each, Rs. 50 payable on application. The entire issue was underwritten by four parties: A, B, C, and D in the proportion of 30% and 25%, 25% and 20% respectively. Under the terms agreed upon, a commission of 2% was payable on the amounts underwritten.

A, B, C, and D also agreed on 'firm'; underwriting of 4,000, 6,000, Nil and 15,000 shares respectively.

The total subscriptions, excluding firm underwriting, including marked applications were for 90,000 shares. Marked applications received were as under :

A	24,000	C	12,000	B	20,000	D	24,000

Ascertain the liability of the individual underwriters and also show the journal entries that you would make in the books of the company. All workings should form part of your answer.

Solution:

If the benefit of firm underwriting is given to individual underwriters.

(i) Total marked applications:

A	B	C	D	
24,000	+20,000	+12,000	+24,000	= 80,000

(ii) Shares subscribed excluding firm underwriting

Total applications	90,000	shares
Less : Marked applications	80,000	shares
Unmarked	10,000	

(iii) Statement showing Liability of underwriters

	A	*B*	*C*	*D*	*Total*
Gross liability (30:25:25:20)	37,500	31,250	31,250	25,000	1,25,000
Less : Marked applications	24,000	20,000	12,000	24,000	80,000
	13,500	11,250	19,250	1,000	45,000
Less : Unmarked (in Gross Ratio)	3,000	2,500	2,500	2,000	10,000
	10,500	8,750	16,750	–1,000	35,000
Less : Firm underwriting	4,000	6,000	–	15,000	25,000
	6,500	2,750	16,750	–16,000	10,000

Less : Surplus of 'D'allotted to A B&C 30:25:25	6,000	5,000	5,000	–	–
	500	–2,250	11,750	–	10,000
Surplus of 'B' allotted	500	–	1,750	–	–
Net liability	–	–	10,000	–	10,000

(iv) Statement of underwriters' liability

Firm	4,000	6,000	–	15,000	25,000
Others	–	–	10,000	–	10,000
	4,000	6,000	10,000	15,000	35,000

(*v*) Amounts due from underwriters

	A	B	C	D	Total
Shares to be subscribed as per (iv) above	4,000	6,000	10,000	15,000	35,000
Amount due @ Rs. 50 per share	2,00,000	3,00,000	5,00,000	7,50,000	17,50,000
Less : Commission due of shares underwritten	75,000	62,500	62,500	50,000	2,50,000
	1,25,000	2,37,500	4,37,500	7,00,000	15,00,000

If the benefit of firm underwriting is not given to individual underwriter:

(i) Total marked applications +24,000 +20,000 +12,000 +24,000 = 80,000

(ii) Shares subscribed excluding

'Firm' underwriting but including		
Marked applications	90,000	shares
'Firm' underwriting	25,000	shares
Total subscription	1,15,000	shares
Less: Marked Applications	80,000	shares
Balance being unmarked	35,000	shares

(vi) Check:

(a)	Taken by public - unmarked applications	10,000	shares
(b)	Public through underwriters - marked	80,000	shares
(c)	By underwriters - under agreement	35,000	shares
		1,25,000	shares

Journal Entry

		Rs.	Rs.
Bank A/c	Dr.	60,00,000	
Underwriting Commission A/c	Dr.	2,50,000	
Equity share Application A/c			62,50,000

Self-Examination Questions

I. Objective Type Questions

1. An underwriter while entering into a contact for issue of shares should be
   (a) An individual
   (b) A partnership or company
   (c) Either (a) or (b)
2. Issue of shares can be underwritten by ________
   (a) Only one underwriter
   (b) At least two or more persons jointly
   (c) Any number of underwriters

[**Answer** :**1.** (c), **2.** (c)]

II. Short Answer Type Questions

3. What do you mean by the term underwriting?
4. Write a short note on Firm underwriting and Partial underwriting along with firm underwriting.

III. Long Answer Type Questions

5. What are the legal provisions regarding underwriting of shares and debentures?
6. "Firm" underwriting. Also give the accounting entries relating to firm underwriting in the books of: (i) the company, (ii) the underwriter.

IV. Practical Problems

7. Noman Ltd. issued 80,000 Equity Shares which were underwritten as follows:

Mr. A	48,000 Equity Shares
Messrs B & Co.	20,000 Equity Shares
Messrs C Corp.	12,000 Eqiuty Shares

The above mentioned underwriters made applications for 'firm' underwritings as follows:

Mr. A	6,400 Equity Shares
Messrs B & Co.	8,000 Equity Shares
Messrs C Corp.	2,400 Equity Shares

The total applications excluding 'firm' underwriting, but including marked applications were for 40,000 Equity Shares.

The marked Applications were as under:

Mr. A	8,000 Equity Shares
Messrs B & Co.	10,000 Equity Shares
Messrs C Corp.	4,000 Equity Shares

(The underwriting contracts provide that underwriters be given credit for 'firm' applications and that credit for unmarked applications be given in proportion to the shares underwritten)

You are required to show the allocation of liability. Workings will be considered as a part of your workings.

8. A joint stock company resolved to issue 10 lakh equity shares of Rs. 10 each at a premium of Re. 1 per share. One lakh of these shares were taken up by the directors of the company, their relatives, associates and friends, the entire amount being received forthwith. The remaining shares were offered to the public, the entire amount being asked for with applications.

   The issue was underwritten by X, Y and Z for a commission @2% of the issue price, 65% of the issue was underwritten by X, while Y's and Z's shares were 25% and 10% respectively. Their firm underwriting was as follows :

X 30,000 shares, Y 20,000 shares and Z 10,000 shares. The underwriters were to submit unmarked applications for shares underwritten firm with full application money along with members of the general public.

Marked applications were as follows:

X 1,19,500 shares, Y 57,500 shares and Z 10,500 shares.

Unmarked applications totalled 7,00,000 shares.

Accounts with the underwriters were promptly settled.

You are required to :

(i) Prepare a statements calculating underwriters' liability for shares other than shares underwritten firm.

(ii) Pass journal entries for all the transactions including cash transactions.

UNIT – 3 : REDEMPTION OF DEBENTURES

Learning Objectives

After studying this unit, you will be able to

- Apply sinking fund method for the redemption of debentures.
- Deal with purchase of own debentures in the open market
- Account for interest on own debentures
- Solve problems based on conversion of debentures

3.1 INTRODUCTION

The most common method of supplementing the capital available to a company is to issue debentures which may either be simple or naked carrying no charge on assets, or mortgage debentures carrying either a fixed or a floating charge on some or all of the assets of the company.

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest. If a charge has been created on any or the entire asset of the company, the nature of the charge and the assets charged are described therein. Since the charge is not valid unless registered with the Registrar, his certificate registering the charge is printed on the bond. It is also customary to create a trusteeship in favour of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders. Issue of debentures has been discussed in detail at Common Proficiency Test level. Students are advised to refer the CPT study material for their understanding.

3.2 REDEMPTION OF DEBENTURES

Debentures are usually redeemable, but a company may also issue irredeemable debentures. Redeemable debentures may be redeemed after a fixed number of years or any time after a certain number of years has elapsed since their issue, on giving a specified notice, or by annual drawing. A company may also purchase its debentures, as and when convenient in the open market and when debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them or, when it is desired, to keep the debentures alive with a view of issuing them again at a later date.

Usually, according to the conditions of the issue, the company is required to create a sinking fund described as Debenture Redemption Reserve Fund, by appropriating annually a certain percentage of, or a fixed sum out of, its profit to its credit and investing the amount thereof either in the purchase of securities which are readily saleable or taking out a policy that shall mature at the time the debentures will fall due for payment. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they shall fall due for payment.

Usually, the balance to the credit of Debenture Redemption Fund, after adjusting therein the amount of appreciation and depreciation of investments on their sale, is either more or less as compared to the amount of debentures which are proposed to be redeemed. If it is in excess, the amount is transferred to the Capital Reserve, on the assumption that it is a capital profit received on the appreciation in the value of investments or settlement of liability for a lesser amount that what was usually payable. On the other hand, if it is short, the deficit is made up by the transfer from Profit and Loss Account. The balance in the account, equal to the amount of debentures redeemed is subsequently transferred to General Reserve.

Debentures sometimes are redeemable at a premium. In such a case, the appropriation to the Redemption Reserve Fund should be sufficient to pay both the amount of debentures and the premium on redemption. If no sinking fund is created a provision for the premium payable for the same should be made out of profit over the period of debentures.

When the company decides to establish the sinking fund at the end of the first year, the amount indicated by the sinking funds tables is credited to the sinking fund account and debited to profit and loss account in the appropriation section. That shows the intention of the company to set aside regular sums of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit sinking fund investments and credit bank. It is sometimes thought that since Government securities or individual debentures are available in multiples of Rs. 100 the investments should be made to the nearest of Rs. 100. This may be true in the case of a new issue otherwise, if securities are purchased from the market, it is possible generally to invest any sum of money that may be desired.

In the subsequent years, when interest is received on investments, the bank account will be debited and interest on sinking fund investments account will be credited. The balance in the latter account will be transferred to the sinking fund account; the annual instalment will be debited to the profit and loss appropriation account and credited to the sinking fund account. The investments every year will be of an amount equal to the annual instalment plus the interest which may have been received in the year concerned. Thus, the sinking fund will go on accumulating each year. [Note : Infact, a notional entry of transfer of interest (and also profit or loss on realisation of sinking fund investments) to the profit and loss account and then again to sinking fund will meet strict requirement of law and AS 13 as well.]

Note: It may be stated that the sinking fund is to be sometimes *non-cumulative*. In that case, interest received on sinking fund investments will not be credited to sinking fund nor it will be invested; the amount of the interest will be credited to the profit and loss account.

In the last year, the sinking fund investments will be realised; the amount will be debited to the bank account and credited to the sinking fund investments account. If there is any loss or profit, it will be transferred to the sinking fund account, with the corresponding entry in the sinking fund investment account. Thus, the amount available by sale of investments will be utilised to pay off the debentures; debentures account will be debited and the bank account credited. The sinking fund account will still show a big credit balance almost equal to the amount of the debentures. This will be transferred to the general reserve.

Note: Investments may be realised from time to time and debentures may be purchased either for immediate cancellation or as investment as the company pleases. In that case, also the profit or loss on the sale of investments should be transferred to the sinking fund investment; the interest saved on such debentures should be debited to the debenture interest account and credited to the interest on sinking fund account directly.

From the accounting point of view, the purchase of debentures involves two problems first, adjustment of the premium or discount, if any paid on their purchase and second, adjustment of interest payable on them. Where a sinking fund is kept the amount of premium or discount is adjusted therein on cancellation so that at the date of redemption, the balance of the Debenture Investments Account, is equal to the Debenture Account. But, if there is none, Debenture Investments are treated like other investments.

As regards interest, where there is a sinking fund, the interest on debentures held as an investment made out of the fund is credited to the sinking fund in exactly the same way as the debentures are outside investments. But where there is no sinking fund, since the adjustment of interest on debentures held as investments would merely involve crediting and debiting the Profit and Loss Account by the same amount, often it is not made. However, on their purchase or cancellation an amount equal to the nominal value of debentures is transferred to General Reserve from the Profit & Loss Account on the consideration that to such an extent the profits will not be available for distribution.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "cum interest"; but if purchased "ex Interest" the interest to the date of purchase would be payable to the seller in addition. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. Thus, in result, a balance in the Account would be left, equal to the interest for the period the debentures were held by the company.

3.3 PURCHASE OF DEBENTURES IN OPEN MARKET

Debentures sometimes are purchased in open market, where there is a Sinking Fund out of the fund and, if there is none, as a general investment; the Debenture Investment Account or Own Debenture Account is debited.

Suppose a company has issued 8% debentures for Rs. 10,00,000, interest being payable on 31st March and 30th September. The company purchases Rs. 50,000 debentures at Rs. 96 on 1st August 2008. This means that the company will have to pay Rs. 48,000 as principal plus Rs. 1,333 as interest for 4 months.

Entry		Rs.	Rs.
Own Debentures	Dr.	48,000	
Interest Account	Dr.	1,333	
To Bank			49,333

It should be noted that even though Rs. 50,000 debentures have been purchased for Rs. 48,000 there is no profit. On purchase of anything, profit does not arise; only on sale, and in this case on cancellation of debentures, will the question of profit or loss could arise.

On 30th September, the company will have to pay Rs. 38,000 as interest to outsiders, *i.e.* 8% on Rs. 9,50,000 for six months. But since the company is keeping the debentures alive, it means, it has saved interest for two months. Therefore, Rs. 667 should be debited to Debentures Interest Account and credited to the Profit and Loss Account. If this entry is passed, it will be noted that the debenture interest account will be debited by the full amount of Rs. 40,000 which is interest for six months on Rs. 10 lakhs. This should be so since in the balance sheet it will be a liability of Rs. 10,00,000. Rs. 50,000 own debentures will be shown on the assets side of the Balance Sheet. However, in the amount column only Rs. 48,000 will be entered.

Suppose out of those debentures Rs. 30,000 is sold at Rs. 98 cum interest on 1st March, 2008 and the remaining Rs. 20,000 is cancelled on 31st March, 2008. The journal entries to be passed will be the following :

		Rs.	Rs.
1st March, 2008			
(1) Bank	Dr.	29,400	
To Own Debentures A/c			28,400
To Interest A/c			1,000
(Sale of Rs. 30,000 Debenture @ Rs. 98 cum interest for 5 months credited to Interest A/c the balance being the sale price proper)			
(2) Profit and Loss A/c	Dr.	400	
To Own Debentures A/c			400
(The loss on Rs. 30,000 Own Debentures whose purchase price was Rs. 28,800 at 96)			

31st March, 2008

8% Debentures A/c	Dr.	20,000	
To Own Debentures A/c			19,200
To Capital Reserve A/c			800
(Cancellation of Rs. 20,000 Debentures)			

It should be noted that the profit on cancellation or redemption of debentures should be treated as a capital profit and, therefore, credited to the capital reserve.

Illustration 1

On January 1, Rama Ltd., had outstanding in its books 500 Debentures of Rs. 100 each interest at 6% per annum. In accordance with the powers in the deed, the directors acquired in the open market Debentures for immediate cancellation as follows :

March 1	Rs. 5,000 at Rs. 98.00 (cum interest)
Aug. 1	Rs. 10,000 at Rs. 100.25 (cum interest)
Dec. 15	Rs. 2,500 at Rs. 98.50 (ex-interest)

Debenture interest is payable half-yearly, on 30th June and 31st Dec.

Show ledger accounts of Debentures, Debenture interest and profit or loss on cancellation, ignoring income-tax.

Solution

6% Debentures Account

1st Half Year

Dr.								*Cr.*
			Rs.	*Rs.*				*Rs.*
Mar. 1	To	Bank-Debentures Purchased	4,850		Jan. 1	By	Balance b/d	50,000
	To	Profit & Loss on cancellation of debenture A/c	150	5,000				
June 30	To	Balance c/d		45,000				
				50,000				50,000

Profit & Loss on Cancellation of Debentures

Date	Particulars	Rs.	Date	Particulars	Rs.
June 30	To Capital Reserve (transfer)	150	Mar. 1	By Debenture Account	150

Debenture Interest Account

Date	Particulars	Rs.	Date	Particulars	Rs.
Mar. 1	To Bank-Interest for 2 months on Rs. 5,000 Debentures	50	June 30	By Profit & Loss A/c	1,400
June 30	To Debenture-holders (Interest) A/c	1,350			
		1,400			1,400

Debenture-holders (Interest) A/c

Date	Particulars	Rs.	Date	Particulars	Rs.
June 30	To Cash	1,350	June 30	By Debenture interest Account (Interest on Rs. 45,000 @ 6% upto 30th June)	1,350

2nd Half Year

6% Debentures Account

Date	Particulars	Rs.	Rs.	Date	Particulars	Rs.
Aug. 1	To Bank-Debenture Purchased		9,975	July 1	By Balance b/d	45,000
	To P & L A/c on Cancellation		25			
Dec. 15	To Bank-Deb. Purchased	2,462.50				
	To Profit & Loss on Cancellation of Debentures	37.50	2,500			
Dec. 31	To Balance c/d		32,500			
			45,000			45,000

Profit & Loss on Cancellation of Debentures A/c

			Rs.				*Rs.*
Dec. 31	To	Capital Reserve —		Aug. 1	By	Debenture A/c	25.00
		Transfer	62.50	Dec. 15	By	Debenture A/c	37.50
			62.50				62.50

Debenture Interest Account

			Rs.				*Rs.*
Aug. 1	To	Bank - Interest for one		Dec.	By	P & L Account	1,093.75
		month on Rs. 10,000	50.00				
Dec. 15	To	Bank	68.75				
Dec. 31	To	Debenture holders	975.00				
			1,093.75				1,093.75

Debenture-holders (Interest) Account

			Rs.				*Rs.*
Dec. 31	To	Bank	975.00	Dec. 31	By	Debenture Interest	
						(on Rs. 32,500 @ 6%	
						for 6 months)	975.00

Tutorial Notes :

(*i*) Profit or loss on redemption of debenture arises only on sale or cancellation; if debentures are purchased but not cancelled the total amount paid (minus the interest to the date of purchase) should be debited to Own Debentures Account and shown as investment in the Balance Sheet. On cancellation, the account will be credited and Debenture Account debited: the difference between the nominal value of the debentures cancelled and the amount standing to the debit on Own Debentures Account will be profit or loss on redemption of debentures.

(*ii*) If debentures are straightway cancelled on purchase, the profit or loss on redemption of debentures will be ascertained by comparing (*i*) the nominal value of debentures cancelled, and (*ii*) the price paid less interest to the date of purchase (if the transaction is cum-interest).

(*iii*) In case the transaction is ex-interest, the interest to the date of transaction will be paid in addition to the settled price and hence profit on redemption will be nominal value minus the settled price.

Illustration 2

The following balances appeared in the books of a company as on December 31, 2007: 6% Mortgage 10,000 debentures of Rs. 100 each; Sinking Fund (for redemption of debentures) Rs. 10, 42,000; Investment Rs. 5,28,000, 4% Government Loan purchased at par and Rs. 5,60,000, 3-1/2% Government paper purchased for Rs. 5,42,000.

The Interest on debentures had been paid up to December 31, 2007.

On February 28, 2008, the investments were sold at Rs. 90 and Rs. 87 respectively and the debentures were paid off at 101, together with accrued interest.

Write up the ledger accounts concerned. The Sinking fund is non cumulative.

Solution

6% Mortgage Debentures Account

Dr.						*Cr.*
2008		*Rs.*	2008			*Rs.*
Feb. 28	To Debenture-holders A/c	10,00,000	Jan. 1	By	Balance b/d	10,00,000

Premium on Redemption of Debentures Account

2008		Rs.	2008			Rs.
Feb. 28	To Debenture-holders A/c	10,000	Feb. 28	By	Sinking Fund A/c	10,000

Debentures Redemption Fund Investment Account

2008		*Rs.*	*2008*			*Rs.*
Jan. 1	To Balance b/d	10,70,000	Feb. 28	By	Bank Rs. 5,28,000 Govt. Loan @ Rs. 90	4,75,200
				By	Bank Rs. 5,60,000 Govt. Paper @ Rs. 87	4,87,200
				By	Sinking Find (Loss)	1,07,600
		10,70,000				10,70,000

Debenture Interest Account

2008		*Rs.*	*2008*			*Rs.*
Feb. 28	To Cash	10,000	Feb. 28	By	Profit & Loss A/c	10,000

Cash Account

2008		*Rs.*	*2008*		*Rs.*
Feb.	To Balance b/d	?	Feb. 28	By Debenture-holders	10,10,000
	To Debentures Redemption Fund investment A/c	9,62,400		By Deb. Interest A/c	10,000
				By Balance c/d	?

Sinking Fund for Redemption of Debentures Account

2008		*Rs.*	*2008*		*Rs.*
Feb.	To D.R.F. Investment Account (Loss)	1,07,600	Jan. 1	By Balance b/d	10,42,000
	To Premium on Redemption of Debentures A/c	10,000		By Profit & Loss (Appropriation) A/c	75,600
	To General Reserve	10,00,000			
		11,17,600			11,17,600

Illustration 3

Sencom Limited issued Rs. 1,50,000 5% Debentures on which interest is payable half yearly on 31st March and 30th September. The company has power to purchase debentures in the open market for cancellation thereof. The following purchases were made during the year ended 31st December, 2007 and the cancellation were made on the following 31st March :

1st March Rs. 25,000 nominal value purchased for Rs. 24,725 ex-interest.

1st September Rs. 20,000 nominal value purchased for Rs. 20,125 cum-interest.

You are required to draw up the following accounts up to the date of cancellation :

(*i*) Debentures Account;

(*ii*) Own Debenture Investment Account; and

(*iii*) Debenture Interest Account.

Ignore taxation and make calculations to the nearest rupee.

Solution :

Sencom Limited

Debenture Account

2007		*Rs.*	2007		*Rs.*
Dec. 31	To Balance c/d	1,50,000	Jan. 1	By Balance b/d	1,50,000

2008			2008		
Mar. 31	To Own Debenture A/c	45,000	Jan. 1	By Balance b/d	1,50,000
	To Balance c/d	1,05,000			
		1,50,000			1,50,000
			Apl. 1	By Balance b/d	1,05,000

Own Debenture Investment Account

		Nominal Cost	Interest	Cost			Nominal Cost	Interest	Cost
2007		*Rs.*	*Rs.*	*Rs.*	2007		*Rs.*	*Rs.*	*Rs.*
Mar. 1	To Bank	25,000	521	24,725	Mar. 31	By Debenture Interest A/c	—	625	—
Sep. 1	To Bank	20,000	417	19,708	Sep. 30	By Debenture Interest A/c	—	1,125	—
Dec. 31	To P & L A/c		1,375		Dec. 31	By Debenture Interest A/c	—	563	—
						By Balance c/d	45,000	—	44,433
		45,000	2,313	44,433			45,000	2,313	44,433
2008					2008				
Jan. 1	To Balance b/d	45,000	563	44,433	Mar. 31	By Debenture Interest A/c	—	1,125	—
Mar. 31	To Capital Reserve (Profit on cancellation)	—	—	567		By 5% Deb. A/c	45,000	—	45,000
	To P & L A/c	—	562	—					
		45,000	1,125	45,000			45,000	1,125	45,000

Debenture Interest Account

2007		*Rs.*	2007		*Rs.*
Mar. 31	To Bank (on Rs. 1,25,000 for 6 months)	3,125	Jan.	By Accrued Interest (on Rs. 1,50,000 @ 5% for 3 months)	1,875
	To Interest on own Debentures	625	Dec. 31	By P & L A/c	7,500

Sep. 30	To	Bank (on Rs. 1,05,000 @ 5% for 3 months)	2,625			
	To	Interest on own Debentures	1,125			
Dec. 31	To	Interest accrued (on Rs. 1,05,000 for 3 months)	1,312			
	To	Interest on own debentures (on Rs. 45,000 for 3 months)	563			
			9,375			9,375
2008				2008		
Mar. 31	To	Bank (on Rs. 1,05,000 for 6 months)	2,625	Jan. 1	By Interest Accrued	1,312
	To	Interest on own debentures (on Rs. 45,000 for 3 months)	563	Mar. 31	By P & L A/c	1,876
			3,188			3,188

Illustration 4

Hindustan Ltd., issued 50,000, 6% Debentures of 100 each on 1st January, 2004. The debentures are redeemable by the creation of a Sinking Fund. The company had the right to call upon the Trustee to apply the Sinking Fund monies in purchasing own debentures, if available below par. The following information is given :

(*a*) The annual appropriation is Rs. 50,000.

(*b*) Sinking Fund Balance as on 1st January, 2007 was Rs. 1,31,942 represented by 6% State Loan at cost of Rs. 74,262 (face value Rs. 80,000) and Sinking Fund cash Rs. 56,830. This cash balance which includes the annual appropriation of Rs. 50,000 was invested in 6% State Loan. The Loan bond, purchased cum interest, had a face value of Rs. 60,000.

(*c*) 1st September, 2007 sold the State Loan of the face value Rs. 40,000 out of loan held on 1st January, 2007 Rs. 38,000 (ex-interest) and the proceeds were applied in purchasing own debentures (face value Rs. 45,000 ex-interest).

(*d*) The debentures purchased are cancelled on 31st December.

(*e*) Interest on State Loan is received on 31st March and 30th September.

(*f*) Interest on debentures is paid on 30th June and 31st December.

(*g*) Debentures outstanding as on 1st January, 2007 were Rs. 4,67,000.

Make ledger entries in the books of the company to give effect to the above.

Solution :

Sinking Fund Account

Dr.							*Cr.*
2007			*Rs.*	*2007*			*Rs.*
Dec. 31	To	General Reserve-transfer	45,000	Jan. 1	By	Balance b/d	1,31,942
Dec. 31	To	Balance c/d	1,52,761	Sep. 1	"	Sinking Fund Investment A/c-profit on sale	869
				Dec. 31	By	Own Debentures-profit on cancellation	6,450
						Interest on S.F. Investment A/c	8,500
						By Profit & Loss A/c	50,000
			1,97,761				1,97,761
				2008			
				Jan. 1	By	Balance b/d	1,52,761

Sinking Fund Investment Account 6% State Loan

			Face Value	Cost				Face Value	Cost
2007			Rs.		2007			Rs.	Rs.
Jan. 1	To	Balance b/d	80,000	74,262	Sep. 1	By	S. Fund Cash A/c	40,000	38,000
	To	S. Fund Cash A/c	60,000	56,780	Dec. 31	By	Balance c/d	1,00,000	93,911
Sep. 1	To	Sinking Fund A/c, profit on sale (assumed, FIFO basis)		869					
			1,40,000	1,31,911				1,40,000	1,31,911
2008									
Jan. 1	To	Balance b/d	1,00,000	93,911					

Own Debenture (S.F.) Account

2007					2007			
Sep. 1	To	S. Fund Cash	45,000	38,550	Dec. 31	By	Debentures A/c cancellation	45,000	45,000
	To	Sinking Fund A/c, profit		6,450					
			45,000	45,000				45,000	45,000

Interest on S.F. Investment Account

2007		*Rs.*	*2007*		*Rs.*
Jan. 1	To Balance b/d (Interest on Rs. 80,000 for 3 months)	1,200	Mar. 31	By S. Fund Cash (on Rs. 1,40,000 for 6 months)	4,200
Jan. 1	To S. Fund Cash (on Rs. 60,000 for 3 months)	900	Sep. 1	By S. Fund Cash (Interest on Rs. 40,000 for 5 months)	1,000
Dec. 31	To Sinking Fund A/c, transfer	8,500	Sep. 30	By S. Fund Cash (Interest on Rs. 1,00,000 for 6 months)	3,000
			Dec. 31	By Debenture Interest (on Rs. 45,000 for 4 months)	900
			Dec. 31	By Balance c/d (on Rs. 1,00,000 for 3 months)	1,500
		10,600			10,600
2008					
Jan. 1	To Balance b/d	1,500			

Debenture Interest Account

2007		Rs.	*2007*		Rs.
June 30	To Bank	14,010	Dec. 31	By P & L A/c, transfer	28,020
Sep. 1	To S. Fund Cash (Interest on Rs. 45,000 Debentures for 2 months)	450			
Dec. 31	" Bank	12,660			
	To Interest on, S.F. Investment (Interest on own debentures for Rs. 45,000 for 4 months)	900			
		28,020			28,020

Sinking Fund Cash Account

2007		*Rs.*	*2007*		*Rs.*
Jan. 1	To Balance b/d	7,680	Jan. 1	By Interest of S.F. Investment A/c	
	To Bank-transfer	50,000			

Mar. 31	To	Interest on S.F. Investments	4,200			(on Rs. 60,000 for 3 months)	900
Sep. 1	To	S.F. Investment 6% State Loan	38,000		By	S.F. Investment A/c 6% State Loan	56,830
	To	Interest on S.F. Investments	1,000	Sep. 1	By	Debenture Interest A/c	450
					By	Own Deb. (S.F.) A/c	38,500
Sep. 30	To	Interest on S.F. Investments	3,000	Dec. 31	By	Balance c/d	7,200
			1,03,880				1,03,880
2008							
Jan. 1	To	Balance b/d	7,200				

6% Debentures Account

2007			*Rs.*	*2007*			*Rs.*
Dec. 31	To	Own Deb. (S.F.) A/c	45,000	Jan. 1	By	Balance b/d	4,67,000
Dec. 31	To	Balance c/d	4,22,000				
			4,67,000				4,67,000

Notes :

(1) The amount to be invested on Jan. 1, 2007 is Rs. 57,680; Rs. 60,000, 6% State Loan has been purchased. Interest till date on this loan is Rs. 900; this has been debited to the interest on S.F. investments Account and the balance; Rs. 56,780, debited to the S.F. Investments Account.

(2) The total amount realised by sale of Rs. 40,000 State loan on Sept. 1, 2007 is Rs. 39,000 *i.e.,* Rs. 38,000 *plus* Rs. 1,000 (interest for 5 months on Rs. 40,000).

(3) Rs. 39,000 is utilised for purchase of Rs. 45,000 own debentures; the interest till date is Rs. 450 — debited to Debenture Interest Account, Rs. 38,550 is debited to Own Debentures (S.F.) Account.

Illustration 5

MM Ltd. had the following among their ledger opening balances on January 1, 2007 :

	Rs.
11% Debentures A/c (2000 issue)	50,00,000
Debenture Redemption Fund A/c	45,00,000
13.5% Debentures in XX Ltd. A/c (Face Value Rs. 20,00,000)	19,50,000
Own Debentures A/c (Face value Rs. 20,00,000)	18,50,000

As 31st December, 2007 was the date for redemption of the 2000 debentures, the company started buying own debentures and made the following purchases in the open market :

1-2-2007 2,000 debentures at Rs. 98 cum-interest.

1-6-2007 2,000 debentures at Rs. 99 ex-interest.

Half yearly interest is due on the debentures on the 30th June and 31st December in the case of both the companies.

On 31st December, 2007, the debentures in XX Ltd. were sold for Rs. 95 each ex-interest. On that date, the outstanding debentures of MM Ltd. were redeemed by payment and by cancellation.

Show the entries in the following ledger accounts of MM Ltd. during 2007 :

(*a*) Debenture Redemption Fund A/c

(*b*) Own Debentures A/c

The face value of a debenture was Rs. 100 (Round off calculations to the nearest rupee.)

Solution :

(*a*) Debenture Redemption Fund Account

2007			*Rs.*	*2007*			*Rs.*
Dec. 31	To	13.5% Deb. in XX Ltd. (Loss on sale of investment)	50,000	Jan. 1	By	Balance b/d	45,00,000
	To	General Reserve (transfer)	49,73,000	Dec. 31	By	13.5% Deb. in XX Ltd.	2,70,000
					By	Own Deb. A/c (Int. on own Deb.)	2,53,000
			50,23,000				50,23,000

11% Debentures Account

2007			*Rs.*	*2007*			*Rs.*
Dec. 31	To	Own Debentures A/c	24,00,000	Jan. 1	By	Balance b/d	50,00,000
	To	Bank	26,00,000				
			50,00,000				50,00,000

(*b*) Own Debentures Account

		Nominal	Int.	Amt.			Nominal	Int.	Amt.
2007		Rs.	Rs.	Rs.	2007		Rs.	Rs.	Rs.
Jan. 1	To Balance b/d	20,00,000	-	18,50,000	June 30	By Debenture Int. A/c		1,32,000	
Feb. 1	To Bank	2,00,000	1,833	1,94,167					

June 1	To Bank	2,00,000	9,167	1,98,000	Dec. 31	By Debenture Int. A/c		1,32,000	
Dec. 31	To Capital Res. (profit on cancellation)			1,57,833		By 11% Deb. Account, cancellation	24,00,000		24,00,000
	To Deb. Redemp. Fund		2,53,000						
		24,00,000	2,64,000	24,00,000			24,00,000	2,64,000	24,00,000

Working Note :

13.5% Debentures in XX Ltd.

2007		Interest Rs.	Amount Rs.	2007		Interest Rs.	Amount Rs.
Jan. 1	To Balance b/d (20,00,000)		19,50,000	June 30	By Bank	1,35,000	
Dec. 31	To Debenture Redemp. Fund	2,70,000		Dec. 31	By Bank	1,35,000	
					By Bank		19,00,000
					By Debenture Redemp. Fund (Loss on sale)		50,000
		2,70,000	19,50,000			2,70,000	19,50,000

Illustration 6

(*i*) Swati Associates Ltd. has issued 10,000 12% Debentures of Rs. 100 each on 1-1-2005. These debentures are redeemable after 3 years at a premium of Rs. 5 per debenture. Interest is payable annually.

(*ii*) On October 1, 2006, it buys 1,500 debentures from the market at Rs. 98 per debenture. These are sold away on June 30, 2005 at Rs. 105 per debenture.

(*iii*) On January 1, 2007 it buys 1,000 debentures at Rs. 104 per debenture from the open market. These are cancelled on April 1, 2005.

(*iv*) On October 1, 2007 it buys 2,000 debentures at Rs. 106 per debenture from the open market. These debentures along with other debentures are redeemed on 31st December, 2007.

Prepare the relevant Ledger Accounts showing the above transactions. Workings should form part of your answer.

Solution :

12% Own Debentures Account

		Interest	Amount			Interest	Amount
2006		Rs.	Rs.	2006		Rs.	Rs.
Oct. 1	To Bank (Rs. 1,50,000)	13,500	1,47,000	Dec. 31	By Debenture Int. A/c	18,000	
	To Profit & Loss A/c	4,500			By Balance c/d		1,47,000
		18,000	1,47,000			18,000	1,47,000
2007				2007			
Jan. 1	To Balance b/d		1,47,000	Apl. 1	By Debenture Int. A/c	3,000	
Jan. 1	To Bank		1,04,000		By 12% Deb. A/c		1,00,000
Apl. 1	To Profit & Loss A/c	3,000			By Profit & Loss A/c		4,000
June 30	To Profit & Loss A/c	9,000	10,500	June 30	By Bank	9,000	1,57,500
Oct. 1	To Bank (Rs. 2,00,000)	18,000	2,12,000	Dec. 31	By Deb. Int. A/c	24,000	
Dec. 31	To Profit & Loss A/c	6,000			By 12% Deb. A/c (cancelled)		2,00,000
					By Profit & Loss A/c		12,000
		36,000	4,73,500			36,000	4,73,500

Note : It has been assumed that all transactions are ex-interest. The amount of such interest has been calculated from the previous 1st January to the date of transaction since the interest is payable annually.

Debenture Interest Account

2005		*Rs.*	*2005*		*Rs.*
Dec. 31	To Bank A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2006			2006		
Dec. 31	To Bank A/c	1,02,000	Dec. 31	By Profit & Loss A/c	1,20,000
	To Int. on Own Deb. A/c	18,000			
		1,20,000			1,20,000
2007			*2007*		
Apl.1	To Int. on Own Deb. A/c	3,000	Dec. 31	By Profit & Loss A/c	1,11,000
Dec. 31	To Int. on Own Deb. A/c	24,000			
	To Bank A/c (on Rs. 7,00,000)	84,000			
		1,11,000			1,11,000

Profit & Loss A/c (Extracts)

2005	To	Deb. Interest A/c	1,20,000				
2006	To	Deb. Interest A/c	1,20,000	2006	By	Int. on Own Deb. A/c (18,000 - 13,500)	4,500
2007	To	Debenture Int. A/c	1,11,000	2007	By	Own Deb. A/c (Profit on cancellation)	10,500
	"	Own Debentures A/c Loss on cancellation (4,000 + 12,000)	16,000	2007	"	Interest on Own Deb. A/c (36,000 - 18,000)	18,000
	"	Premium on Redemption of Debentures on Rs. 7,00,000 @ 5%	35,000				

Premium on Redemption of Debentures A/c

2005				2005			
Dec. 31	To	Bank	35,000	Dec. 31	By	Profit & Loss A/c	35,000

12% Debentures Account

2005			Rs.	2005			Rs.
Dec. 31	To	Balance c/d	10,00,000	Jan. 1	By	Bank	10,00,000
2006				2006			
Dec. 31	To	Balance c/d	10,00,000	Jan. 1	By	Balance b/d	10,00,000
2007				2007			
Apl. 1	To	Own Deb. A/c	1,00,000	Jan. 1	By	Balance b/d	10,00,000
Dec. 31	"	Own Deb. A/c	2,00,000				
	"	Bank	7,00,000				
			10,00,000				10,00,000

Working Notes :

(*i*) Interest paid on purchase of own debentures:

Date	*Nominal Amount*	*Period*	*Rate*	*Interest*
2006 Oct. 1	Rs. 1,50,000	9 months	12%	13,500
2007 Oct. 1	Rs. 2,00,000	9 months	12%	18,000

(*ii*) Interest credited to Interest on Own Debenture A/c

2006 Dec. 31	Rs. 1,50,000	12 months	12%	18,000

2007 April 1	Rs. 1,00,000	3 months	12%	3,000
2007 June 30	Rs. 1,50,000	6 months	12%	9,000
2007 Dec. 31	Rs. 2,00,000	12 months	12%	24,000

(*iii*) Profit/Loss on cancellation/sales is difference between cost or nominal value and sales price.

Illustration 7

The Summary Balance Sheet of Chanjit Ltd. at March 31, 2006 was :

	Rs.		*Rs.*
Issued and Fully Paid Share Capital : 50,000 6% Redeemable 'A' Pref. Shares of Rs. 10 each	5,00,000	Sundry Assets	21,55,000
40,000 7% Redeemable 'B' Pref. Shares of Rs. 10 each (less calls in arrear on 5,000 shares)	3,95,000	Own Debentures (Nominal Rs. 1,20,000)	1,05,000
50,000 Equity shares of Rs. 10 each	5,00,000	Cash at Bank	5,80,000
Securities Premium Account	1,00,000		
Capital Reserve Account	1,00,000		
Profit and Loss Account	4,00,000		
General Reserve Account	2,00,000		
5% Debentures	4,00,000		
Creditors	2,45,000		
	28,40,000		28,40,000

On September 30, 2006 following were due for redemption :

(1) The Rs. 4,00,000 5% Debentures at a premium of 10 per cent.

(2) The Rs. 5,00,000 6% 'A' Preference Shares at a premium of Re. 1 per share.

(3) The Rs. 4,00,000 7% 'B' Preference Shares at a premium of 5 per cent.

It was decided :

(*a*) Out of the trading profits of Rs. 2,00,000 earned in the seven months to Oct. 31, 2006, to pay the debenture interest and preference dividends for the half year to September 30, 2006;

(*b*) to offer to the debenture holders new 6% debentures 2006 or repayment in cash. The offer of new debentures in exchange for the original holding was accepted by 50 per cent of the debenture holders including those held by Chanjit Ltd. The whole transaction was completed on September 30, 2006, and a transfer was made to General Reserve of a sum equivalent to the cash applied on redemption;

(*c*) to make an issue of 60,000 Equity Shares of Rs. 10 each at a premium of Rs. 2.50 per share. This was done on August 31, 2006 and all moneys were received on that date;

(*d*) to repay in cash both 'A' and 'B' Preference shares, and this was carried through on September 30, 2006.

You are required to (1) show the ledger accounts recording the above transaction in the company books and (2) give the company's Balance Sheet at Oct. 31, 2006. Ignore expenses and taxation.

Solution :

5% Debentures Account

Dr.					*Cr.*
2006		*Rs.*	*2006*		*Rs.*
Sep. 30	To 6% Debentures A/c	2,00,000	Apl. 1	By Balance b/d	4,00,000
	" 5% Debentureholders Account	2,00,000			
		4,00,000			4,00,000

Own Debentures Account

2006		Rs.	2006		Rs.
Apl. 1	To Balance b/d	1,05,000	Sep. 30	By New Own Deb. A/c	1,05,000

(New) Own Debentures Account

2006		Rs.	2006		Rs.
Sep. 30	To (Old) Own Deb. A/c	1,05,000	Sep. 30	By Balance b/d	1,05,000
	To Balance c/d	1,05,000			

6% Debentures Account

2006		Rs.	2006		Rs.
Oct. 31	To Balance b/d	2,00,000	Sep. 30	By 5% Debentures A/c	2,00,000
			Nov. 1	By Balance b/d	2,00,000

5% Debenture holders Account

2006		Rs.	2006		Rs.
Sep. 30	To Bank A/c	2,20,000	Sep. 30	By 5% Debentures A/c	2,00,000
				" Premium on Redemp. of Debentures A/c	20,000
		2,20,000			2,20,000

General Reserve Account

2006		Rs.	2006		Rs.
Oct. 31	To Balance c/d	4,00,000	Apl. 1	By Balance b/d	2,00,000
			Sep. 30	" Profit & Loss A/c	2,00,000
		4,00,000			4,00,000
			Nov. 1	By Balance b/d	4,00,000

Profit and Loss Account

Dr.					Cr.
2006		Rs.	2006		Rs.
Sep. 30	To General Reserve A/c	2,00,000	Apl. 1	By Balance b/d	4,00,000
	" Capital Redemption Reserve A/c	3,00,000	Apl. 1 to Oct. 30	" Bank A/c	2,00,000
	" Dividends A/c	29,000			
	" Interest on 5% Deb. A/c	10,000			
Oct. 30	" Balance c/d	61,000			
		6,00,000			6,00,000
			Nov. 1	By Balance b/d	61,000

Note : It has been assumed that cash balance has increased by the sum of profit earned.

Equity Share Capital Account

2006		Rs.	2006		Rs.
Oct. 31	To Balance c/d	11,00,000	Apl. 1	By Balance b/d	5,00,000
			Aug. 31	" Bank A/c	6,00,000
		11,00,000			11,00,000
			Nov. 1	By Balance b/d	11,00,000

Securities Premium Account

2006		Rs.	2006		Rs.
Sep. 30	To Premium on Redemp. of Preference Shares A/c	70,000	Apl. 1	By Balance b/d	1,00,000
	" Premium on Redemp. of Debentures A/c	20,000	Aug. 30	" Bank A/c	1,50,000
	" Balance c/d	1,60,000			
		2,50,000			2,50,000
			Nov. 1	By Balance b/d	1,60,000

Cash at Bank

2006		Rs.	2006		Rs.
Apl. 1	To Balance b/d	5,80,000	Sep. 30	By 6% 'A' Preference Shareholders A/c	5,50,000
Aug. 31	" Equity Share Capital A/c	6,00,000	"	7% 'B' Preference Shareholders A/c	3,67,500
	" Share Premium A/c	1,50,000		By 5% Debentureholders Account	2,20,000
Oct. 31	" Profit & Loss A/c	2,00,000		" Pref. Dividend A/c	29,000
				" Interest on 5% Deb. A/c	10,000
			Oct. 31	" Balance c/d	3,53,500
		15,30,000			15,30,000
Nov. 1	To Balance b/d	3,53,500			

6% 'B' Preference Shareholders Account

2006		Rs.	2006		Rs.
Sep. 30	To Bank A/c	3,67,500	Sep. 30	By 7% 'A' Preference Shares Capital A/c (35,000 shares)	3,50,000
				" Premium on Redemp. of Pref. Shares A/c	17,500
		3,67,500			3,67,500

6% 'A' Preference Shareholders Account

2006		Rs.	2006		Rs.
Sep. 30	To Bank A/c	5,50,000	Sep. 30	By 6% 'A' Preference Share Capital A/c	5,00,000
				" Premium on Redemp. of Pref. Shares A/c	50,000
		5,50,000			5,50,000

Premium on Redemption of Preference Shares Account

2006		Rs.	2006		Rs.
Sep. 30	To 6% 'A' Pref. Shareholders Account	50,000	Sep. 30	By Share Premium A/c	70,000
	" 7% 'B' Pref. Shareholders Account	17,500			
	" Balance c/d	2,500			
		70,000			70,000
			Oct. 1	By Balance b/d	2,500

Premium on Redemption of Debentures Account

2006		Rs.	2006		Rs.
Sep. 30	To 5% Debentureholders	20,000	Sep. 30	By Share Premium A/c,	20,000

Capital Redemption Reserve Account

2006		Rs.	2006		Rs.
Oct. 31	To Balance c/d	3,00,000	Sep. 30	By Profit & Loss A/c	3,00,000
			Nov. 1	By Balance b/d	3,00,000

Balance Sheet of Chanjit Ltd. as on 31st Oct., 2006

Liabilities		*Rs.*	*Assets*	*Rs.*
Share Capital :			Sundry Assets	21,55,000
Authorised :			*Investment*	
Issued and Subscribed			Own Debenture (Nominal	
1,10,000 Equity Shares of			value Rs. 1,20,000	1,05,000
Rs. 10 each fully paid up		11,00,000	*Current Assets, Loans*	
7% B Pref. Share Capital			*and Advances* :	
(pending redemption)	50,000		(A) Current Assets	
Less : Calls in arrear	5,000	45,000	Cash at Bank	3,53,500

Reserve and Surplus :		(B) Loans and Advance	*Nil*
Capital Reserve	1,00,000		
Capital Redemption Reserve A/c	3,00,000		
Share Premium	1,60,000		
General Reserve	4,00,000		
Profit & Loss Account	61,000		
Secured Loans : 6% Debentures	2,00,000		
Current Liabilities and Provisions :			
(A) Current Liabilities :			
Creditors	2,45,000		
(B) Provisions :			
Premium payable on redemption			
of 5,000 B Preference Share	2,500		
	26,13,500		26,13,500

Illustration 8

The Balance Sheet of BEE CO. LTD. on 31st January, 2008 read as under :

	Rs.		Rs.
Share Capital :		Freehold property	1,15,000
Authorised :		Stock	1,35,000
30,000 Equity Shares of Rs. 10 each	3,00,000	Debtors	75,000
Issued and Subscribed :		Cash	30,000
20,000 Equity Shares of Rs. 10 each		Balance at Bank	2,20,000
fully paid	2,00,000		
Profit and Loss Account	1,20,000		
12% Debentures	1,20,000		
Creditors	1,15,000		
Proposed Dividends	20,000		
	5,75,000		5,75,000

At the Annual General Meeting it was resolved :

(*a*) To pay the proposed dividend of 10 per cent in cash.

(*b*) To give existing shareholders the option to purchase one Rs. 10 share at Rs. 15 for every four shares (held prior to the bonus distribution), this option being taken up by all shareholders.

(*c*) To issue one bonus share for every four shares held.

(*d*) To repay the debentures at a premium of 3 per cent.

Give the necessary journal entries and the company's Balance Sheet after these transactions are completed.

Solution :

Journal of BEE Co. Ltd.

		Dr.	Cr.
		Rs.	Rs.
Proposed Dividend A/c	Dr.	20,000	
To Bank A/c			20,000
(Proposed Dividend paid to existing shareholders)			
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
(Application money received on 5,000 shares @ Rs. 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000
(Share application money on 5,000 shares @ Rs. 10 per share transferred to Share Capital Account, and Rs. 5 per share to securities Premium Account *vide* Board's Resolution dated....)			
Securities Premium A/c	Dr.	25,000	
Profit & Loss A/c	Dr.	25,000	
To Bonus to Shareholders A/c			50,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:4 *vide* General Body's resolution dated...)			
Bonus to Shareholders A/c	Dr.	50,000	
To Equity Share Capital A/c			50,000
(Issue of bonus shares in the ratio of 1 for 4 *vide* Board's resolution dated....)			

12% Debentures A/c	Dr.	1,20,000	
Premium Payable on Redemption A/c	Dr.	3,600	
To Debenture holders A/c			1,23,600
(Amount payable to debentures holders)			
Profit & Loss A/c	Dr.	3,600	
To Premium Payable on Redemption A/c			3,600
(Premium payable on redemption charged to Profit & Loss A/c)			
Debenture holders A/c	Dr.	1,23,600	
To Bank A/c			1,23,600
(Amount paid to debenture holders on redemption)			

Balance Sheet of BEE Co. Ltd. as on...... (after completion of transactions)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital		*Fixed Assets*	
Authorised, Issued & Subscribed :		Property	1,15,000
30,000 shares of Rs. 10 each		*Investments*	
fully paid	3,00,000	Stock trade	1,35,000
(5,000 shares of Rs. 10 each,		Sundry Debtors	75,000
fully paid issued as bonus		Cash at Bank	1,51,400
shares out of share premium		Cash in hand	30,000
and P&L Account)			
Reserve and Surplus			
Profit & Loss A/c	91,400		
Secured Loans	—		
Unsecured Loans	—		
Current Liabilities & Provisions			
Sundry Creditors	1,15,000		
	5,06,400		5,06,400

Note : The number of bonus shares issued has been calculated on the basis of issued capital before rights issued *i.e.,* 20,000 shares (and not 25,000 shares after rights issue).

Illustration 9

The summarised Balance Sheet of Convertible Limited, as on 30th June, 2008, stood as follows:

Liabilities	Rs.
Share Capital : 5,00,000 equity shares of Rs. 10 each fully paid	50,00,000
General Reserve	75,00,000
Debenture Redemption Fund	50,00,000
13.5% Convertible Debentures, 1,00,000 Debentures of Rs. 100 each	1,00,00,000
Other loans	50,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000
Assets :	
Fixed Assets (at cost less depreciation)	1,60,00,000
Debenture Redemption Fund Investments	40,00,000
Cash and bank Balances	50,00,000
Other Current Assets	2,00,00,000
	4,50,00,000

The debentures are due for redemption on 1st July, 2008. The terms of issue of debentures provided that they were redeemable at a premium 5% and also conferred option to the debenture holders to convert 20% of their holding into equity shares at a predetermined price of Rs. 15.75 per share and the payment in cash.

Assuming that :

(*i*) except for 100 debenture holders holding totally 25,000 debentures, the rest of them exercised the option for maximum conversion.

(*ii*) the investments realise Rs. 44 lakhs on sale; and

(*iii*) all the transactions are put through, without any lag, on 1st July, 2008.

Redraft the balance sheet of the company as on 1st July, 2008 after giving effect to the redemption. Show your calculations in respect of the number of equity shares to be allotted and the cash payment necessary.

Solutions :

Convertible Limited

Balance Sheet as on July 1, 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital :		*Fixed Assets :*	
6,00,000 Equity Shares of		Fixed Assets (at cost	
Rs. 10 each	60,00,000	less depreciation)	1,60,00,000

Reserve & Surplus :		*Investments :*	
General Reserve	1,24,00,000	*Current Assets*	
Securities Premium Account	5,75,000	*Loan & Advances :*	
Secured Loans :		Other Current Assets	2,00,00,000
Unsecured Loans :		Cash & Bank Balance	4,75,000
Other Loans	50,00,000	Miscellaneous Expenditure	
Current Liabilities and Provisions :		*& Losses :*	—
Current Liabilities and Provisions	1,25,00,000		
	3,64,75,000		3,64,75,000

Working Notes :

(i) Calculation of number of shares to be allotted :

Total number of debentures	1,00,000
Less : number of debentures not opting for conversion	25,000
	75,000
20% of 75,000	15,000
Redemption value of 15,000 debentures	Rs. 15,75,000

Number of Equity Shares to be allotted :

$$= \frac{15,75,000}{15.75} = 1,00,000 \text{ shares of Rs. 10 each.}$$

(ii) Calculation of Cash to be paid :

	Rs.
Number of debentures	1,00,000
Less : number of debentures to be converted into equity shares	15,000
	85,000
Redemption value of 85,000 debentures (85,000 × Rs. 105)	Rs. 89,25,000

(iii) Cash and Bank Balance :

Balance before redemption	50,00,000
Add : Proceeds of investments sold	44,00,000
	94,00,000
Less : Cash paid to debenture holders	89,25,000
	4,75,000

(iv) Calculation of General Reserve :

Opening Balance	75,00,000
Add : Debenture Redemption Fund transfer	50,00,000
	1,25,00,000
Profit on sale of investments	4,00,000
	1,29,00,000
Less : Premium on redemption of debentures	5,00,000
	1,24,00,000

Note : The premium on redemption of debentures may also be adjusted against Securities Premium Account.

3.4 LIABILITY OF THE COMPANY TO CREATE SECURITY AND DEBENTURE REDEMPTION RESERVE :

New Section 117C has been inserted by the Companies Amendment Act in the Companies Act. The Section states as follows :

(1) Where a company issues debentures after the commencement of this Act, it shall create a debenture redemption reserve for the redemption of such debentures, to which adequate amounts shall be credited, from out of its profits every year until such debentures are redeemed.

(2) The amounts credited to the debenture redemption reserve shall not be utitlised by the company except for the purpose aforesaid.

(3) The company referred to in sub-section (1) shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(4) Where a company fails to redeem the debentures on the date of maturity, the Company Law Board may, on the application of any or all the holders of debentures shall, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon.

(5) If default is made in complying with the order of the Company Law Board under sub-section (4), every officer of the company who is in default, shall be punishable with imprisonment which may extend to three years and shall also be liable to a fine of not less than five hundred rupees for every day during which such default continues.

Self-Examinations Questions

I. Objective Type Questions

Use the following information for questions 1 to 3

On March 31, 2007, the balance of 12% Debentures of Rs.100 each of C Ltd. was Rs.5,00,000. The company reserves the right to redeem the debentures in any year by purchase in the open market. Interest on debentures is payable on September 30 and March 31, every year.

On July 1, 2007, the company purchased 1,000 of its 12% Debentures as investment at Rs.99 cum-interest.

On August 01, 2007, it purchased another 1,000 of its debentures at Rs.98 ex-interest. The company cancelled 2,000 own debentures on September 01, 2007.

1. Amount debited to Own Debentures Account at the time of purchase on 01.07.2007 = ?
   (a) Rs 1,00,000
   (b) Rs 99,000
   (c) Rs 98,000
   (d) Rs 96,000
2. Amount debited to Own Debentures Account at the time of purchase on 01.08.2007 = ?
   (a) Rs 1,00,000
   (b) Rs 99,000
   (c) Rs 98,000
   (d) Rs 97,000
3. The profit/loss on cancellation of own debentures is
   (a) Rs.1,000 (Loss)
   (b) Rs.6,000 (Profit)
   (c) Rs.3,000 (Profit)
   (d) Rs.2,000 (Loss)

4. The periodical interest received in respect of investments made on account of debenture redemption fund is credited to ________.

   (a) Interest income account

   (b) Debenture holders account

   (c) Debentures account

   (d) Debenture redemption fund account

5. Which of the following statements is **true**?

   (a) A debenture holder is an owner of the company

   (b) A debenture holder can get his money back only on the liquidation of the company

   (c) A debenture issued at a discount can be redeemed at a premium

   (d) A debenture holder receives interest only in the event of profits

6. When interest on own debentures becomes due, it will be credited to

   (a) Profit and loss account

   (b) Own debenture account

   (c) Debenture interest account

   (d) Interest on own debenture account

7. Which of the following statements is **false**?

   (a) Debentures can be redeemed by payment in lump sum at the end of a specified period

   (b) Debentures cannot be redeemed during the life time of the company

   (c) Debentures can be redeemed by payments in annual installments

   (d) Debentures can be purchased in the open market for cancellation

Use the following information for questions 8 to 10

8. D Ltd. redeemed its 12% Debentures of Rs.5,00,000 at a premium of 2%. The offer for redemption was as follows:

   ♦ Holders can have cash, or

- They could utilize their redemption money in either

(i) Subscribing to 8% Cumulative Preference Shares of Rs.100 each issued at a premium of 5% or

(ii) Taking up 10% Debentures of Rs.100 each, issued at a discount of 10%

Persons holding Rs.2,00,000 debentures agreed to take immediate cash payment. Other debenture holders holding Rs.1,94,200 Debentures agreed to subscribe to the Preference Shares. The balance of 12% Debentures were replaced by the new series of 10% Debentures.

9. The amount of 12% Debentures outstanding after effecting the above transactions is ______.

(a) Rs 3,00,000

(b) Rs 1,00,000

(c) Rs 50,000

(d) Nil

10. Face value of 8% Preference shares given to 12% debenture holders = ?

(a) Rs 1,94,200

(b) Rs 1,98,084

(c) Rs 9,432

(d) Rs 1,88,652

[**Answer: 1.** (d), **2.** (c), **3.** (b), **4.** (d), **5.** (c), **6.** (d), **7.** (b), **8.** (d), **9.** (d), **10.** (d)]

II. Short Answer Type Questions

11. Explain term 'Debenture Redemption Fund' and how is it created?

12. Give the Accounting treatment for

(i) Interest on own debentures

(ii) Redemption of debentures out of profit

(iii) Cancellation of own debentures.

III. Long Answer Type Questions

13. Explain how a company purchases its own shares from the open market

14. Describe with examples the procedure of redemption of debentures by the creation of Debenture Sinking Fund method.

IV. Practical Questions

15. The summarised Balance Sheet of Apple Limited, as on 30th June, 2006, stood as follows :

Liabilities :	Rs.
Share Capital : 5,00,000 equity shares of Rs. 10 each fully paid	50,00,000
General Reserve	75,00,000
Debenture Redemption Fund	50,00,000
13.5% Convertible Debentures 1,00,000 Debentures of Rs. 100 each	1,00,00,000
Other loans	50,00,000
Current Liabilities and Provisions	1,25,00,000
	4,50,00,000
Assets :	Rs.
Fixed Assets (at cost less depreciation)	1,60,00,000
Debenture Redemption Fund Investments	40,00,000
Cash and bank Balances	50,00,000
Other Current Assets	2,00,00,000
	4,50,00,000

The debentures are due for conversion on 1st July, 2006. The terms of issue of debentures provided that 50% of the convertible debentures were to be converted into equity shares and the balance would be repayable in cash at 10% premium. For conversion one equity share of Rs. 10 each would be issued at a premium of Rs. 40 each.

(*i*) the investments realise Rs. 44 lakhs on sale; and

(*ii*) all the transactions are put through, without any lag, on 1st July, 2006.

Redraft the balance sheet of the company as on 1st July, 2006 after giving effect to the conversion and redemption. Show your calculations in respect of the number of equity shares to be allotted and the cash payment necessary.

16. On 1st January, 2006 A Ltd. made an issue of 10,000 12% debentures of Rs. 100 each at Rs. 98 per debenture. The terms of issue provided for the redemption of Rs. 50,000 debentures every year commencing from 2007 either by purchase or by drawing lots, at par, at the company's option. Profit, if any, on the redemption of debentures is to be transferred to capital reserve account. The company's accounting year ends on 31st December. Interest is payable on 30th June and 31st December.

    During 2006, the company wrote-off Rs. 5,000 from debenture discount account.

    During 2007, the company purchased for cancellation of debentures of the face value of:

    (*i*) Rs. 20,000 at Rs. 97 per debenture on 30th June, and

    (*ii*) Rs. 30,000 at Rs. 96 per debenture on 31st December.

    Show how these items will appear in the financial statements for the year ended 31st December, 2007. Also show the corresponding figures for the previous year. Show your workings.

17. Indebted Ltd., issued 10% Debentures at par for 8 lakhs on 1st January, 2001. Interest was payable half yearly on 30th June and 31st December every year. Under the terms of the trust deed, the debentures are redeemable at par (after the years of issue) by the company purchasing them in the open market and cancelling them with a minimum redemption of Rs. 80,000 every year. In case, there was a short-fall in redemption by the company by open market operations, the shortfall would be made good by the company by payment on the last day of the accounting year to the trustees who would draw lots and redeem the debentures.

    The company purchased its own debentures for cancellation as under :

    (*a*) 30th September, 2004 Rs. 1,00,000 at Rs. 98 cum-interest.

    (*b*) 31st May, 2005 Rs. 60,000 at Rs. 95 ex-interest.

    (*c*) 31st July, 2005 Rs. 90,000 at Rs. 96 ex-interest.

The company carried out its obligations under the deed. Prepare the following ledger accounts for calender years 2004, 2005 and 2006 :

(*i*) Debentures account, (*ii*) Debentures Redemption account, and (*iii*) Debentures Interest account. Ignore taxation.

18. Nandi Farms Limited issued 2,000 10% debentures of Rs. 100 each at par in January, 1996, redeemable at par on December 31, 2005. Interest was payable on debentures on 30th June and 31st December in each year. For redemption, the company has set up sinking fund by appropriating a sum of Rs. 16,000 annually and the amount was invested. As per the terms of issue the company is empowered to purchase its own debentures in the market and to keep them available for reissue. On December 31, 2004 the following balances were extracted from the company's books :

(*a*) Sinking fund investments in Government securities at cost Rs. 1,63,760

(*b*) 10% debenture stock Rs. 2,00,000

(*c*) Sinking fund account Rs. 1,86,000

The transactions during the year ended 31st December, 2005 included the following:

January 1	Government securities of the par value of Rs. 16,000 were purchased for Rs. 15,840.
February 1	60 own debentures were purchased cum-interest at a cost of Rs. 5,880.
September 1	Government securities worth Rs. 6,000 were disposed off at Rs. 5,900 ex-interest.
September 1	60 own debentures were purchased ex-interest for Rs. 5,900 with the proceeds of investment sold.
December 22	The balance of the sinking fund investment sold cum-interest at 99 per cent.

The debenture stock was redeemed and cancelled in accordance with the terms of issue.

Appropriate for the year from the Profit and Loss Account to Sinking Fund Account to the extent of amount actually required for redemption.

You are required to prepare the following accounts in the books of the company for the year ended 31st December, 2005 :

(*i*) Sinking Fund Account

(*ii*) Sinking Fund Investment Account.

Show your workings clearly.

UNIT – 4 : AMALGAMATION AND RECONSTRUCTION

Learning Objectives

- After studying this unit, you will be able to solve the advanced problems on amalgamation and reconstruction of companies.

4.1 Advanced Problems

You must have studied the concepts of amalgamation and reconstruction of companies in Chapters 5 and 6 in Paper Accounting of Integrated PCC – Group I. In this unit, we will deal with some advanced problems for advanced knowledge on the topic.

Illustration 1

Following is the Balance Sheet of ABC Ltd. as at 31st March, 2007:

Liabilities	Rs.	Assets	Rs.
Share capital:		Plant and machinery	9,00,000
2,00,000 Equity shares of		Furniture and fixtures	2,50,000
Rs 10 each fully paid up	20,00,000	Patents and copyrights	70,000
6,000 8% Preference shares of Rs. 100 each	6,00,000	Investments (at cost) (Market value Rs. 55,000)	68,000
9% Debentures	12,00,000	Stock	14,00,000
Bank overdraft	1,50,000	Sundry debtors	14,39,000
Sundry creditors	5,92,000	Cash and bank balance	10,000
		Profit and Loss A/c	4,05,000
	45,42,000		45,42,000

The following scheme of reconstruction was finalised:

(i) Preference shareholders would give up 30% of their capital in exchange for allotment of 11% Debentures to them.

(ii) Debentureholders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.

(iii) Stock equal to Rs.5,00,000 in book value will be taken over by sundry creditors in full settlement of their dues.

(iv) Investment value to be reduced to market price.

(v) The company would issue 11% Debentures for Rs.3,00,000 and augment its working capital requirement after settlement of bank overdraft.

Pass necessary Journal Entries in the books of the company. Prepare Capital Reduction account and Balance Sheet of the company after internal reconstruction.

Answer

In the Books of ABC Ltd.

Journal Entries

Particulars		*Rs.*	*Rs.*
8% Preference share capital A/c	Dr.	6,00,000	
To Preference shareholders A/c			4,20,000
To Capital reduction A/c			1,80,000
[Being 30% reduction in liability of preference share capital]			
Preference shareholders A/c	Dr.	4,20,000	
To 11% Debentures A/c			4,20,000
[Being the issue of debentures to preference shareholders]			
9% Debentures A/c	Dr.	12,00,000	
To Debenture holders A/c			12,00,000
[Being transfer of 9% debentures to debenture holders A/c]			
Debenture holders A/c	Dr.	12,00,000	
To Plant & machinery A/c			9,00,000
To Capital reduction A/c			3,00,000
[Settlement of debenture holders by allotment of plant & machinery]			

Sundry creditors A/c	Dr.	5,92,000	
To Stock A/c			5,00,000
To Capital reduction A/c			92,000
[Being settlement of creditors by giving stocks]			
Bank A/c	Dr.	3,00,000	
To 11% Debentures A/c			3,00,000
[Being fresh issue of debentures]			
Bank overdraft A/c	Dr.	1,50,000	
To Bank A/c			1,50,000
[Being settlement of bank overdraft]			
Capital reduction A/c	Dr.	5,72,000	
To Investment A/c			13,000
To Profit and loss A/c			4,05,000
To Capital reserve A/c			1,54,000
[Being decrease in investment and profit and loss account (Dr. bal.); and balance of capital reduction account transferred to capital reserve]			

Capital Reduction Account

		Rs.			*Rs.*
To	Investments A/c	13,000	By	Preference share capital A/c	1,80,000
To	Profit and loss A/c	4,05,000	By	9% Debenture holders A/c	3,00,000
To	Capital reserve A/c	1,54,000	By	Sundry creditors A/c	92,000
		5,72,000			5,72,000

Balance Sheet of ABC Ltd. (And Reduced)

As on 31st March 2007

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital		Plant & machinery (9,00,000 – 9,00,000)	Nil
2,00,000 Equity shares of Rs.10 each fully paid-up	20,00,000	Furniture & fixtures	2,50,000
Capital reserve	1,54,000	Patents & copyrights	70,000
11% Debentures (Rs.4,20,000 + Rs.3,00,000)	7,20,000	Investments (Rs.68,000 – Rs.13,000)	55,000
		Stock (Rs.14,00,000 – Rs.5,00,000)	9,00,000
		Sundry debtors	14,39,000
		Cash at bank (refer W.N.)	1,60,000
	28,74,000		28,74,000

Working Note:

Cash at bank = Opening balance + 11% Debentures issued – Bank overdraft paid

= Rs.10,000 + Rs.3,00,000 – Rs.1,50,000

= Rs.1,60,000

Illustration 2

S.P. Construction Co. finds itself in financial difficulty. The following is the balance sheet on 31 Dec. 2005.

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital		Land	1,56,000
20,000 Equity Shares of Rs.		Building (net)	27,246
10 each fully paid	2,00,000	Equipment	10,754
5% Cum. Pref. Shares of		Goodwill	60,000

Rs. 10 each fully paid	70,000	Investments (Quoted) in shares	27,000
8% Debentures	80,000	Stock	1,20,247
Loan from Directors	16,000	Sundry Debtors	70,692
Trade Creditors	96,247	Profit & Loss Account	39,821
Bank Overdrafts	36,713		
Interest Payable on Debentures	12,800		
	5,11,760		5,11,760

The authorised capital of the company is 20,000 Equity Shares of Rs. 10 each and 10,000 5% Cum. Preference Shares of Rs. 10 each.

During a meeting of shareholders and directors, it was decided to carry out a scheme of internal reconstruction. The following scheme has been agreed :

(1) The equity shareholders are to accept reduction of Rs. 7.50 per share. And each equity share is to be redesignated as a share of Rs. 2.50 each.

(2) The equity shareholders are to subscribe for a new share on the basis of 1 for 1 at a price of Rs. 3 per share.

(3) The existing 7,000 Preference Shares are to be exchanged for a new issue of 3,500 8% Cumulative Preference Shares of Rs. 10 each and 14,000 Equity Shares of Rs. 2.50 each.

(4) The Debenture holders are to accept 2,000 Equity Shares of Rs. 2.50 each in lieu of interest payable.

The interest rate is to be increased to 9 ½%. Further Rs. 9,000 of this 9 ½% Debentures are to be issued and taken up by the existing holders at Rs. 90 for Rs. 100.

(5) Rs. 6,000 of directors' Loan is to be credited. The balance is to be settled by issue of 1,000 Equity Shares of Rs. 2.50 each.

(6) Goodwill and the profit and loss account balance are to be written off.

(7) The investment in shares is to be sold at current market value of Rs. 60,000.

(8) The bank overdraft is to be repaid.

(9) Rs. 46,000 is to be paid to trade creditors now and balance at quarterly intervals.

(10) 10% of the debtors are to be written off.

(11) The remaining assets were professionally valued and should be included in the books of account as follows :

	Rs.
Land	90,000
Building	80,000
Equipment	10,000
Stock	50,000

(12) It is expected that due to changed condition and new management operating profit will be earned at the rate of Rs. 50,000 p.a. after depreciation but before interest and tax.

Due to losses brought forward it is unlikely that any tax liability will arise until 2007.

You are required to show the necessary journal entries to effect the reconstruction scheme; prepare the balance sheet of the company immediately after the reconstruction.

Solution :

S.P. Construction Co. Ltd.

		Dr.	Cr.
		Rs.	Rs.
Equity Share Capital (Rs. 10) A/c	Dr.	2,00,000	
To Capital Reduction A/c			1,50,000
To Equity Share Capital (Rs. 2.50) A/c			50,000
(Equity shareholders rights of Rs. 10 shares reduced to a share of Rs. 2.50 vide Board's Resolution dated..., the amount of sacrifice credited to Capital Reduction Account)			
Bank A/c	Dr.	60,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			10,000
(20,000 Equity shares issued for cash at premium of Re. 0.50 per share vide Board's Resolution dated...)			

5% Preference share capital A/c	Dr.	70,000	
To 8% Pref. Share Capital A/c			35,000
To Equity Share Capital A/c			35,000
(5% Preference share capital converted into 3,500 8% preference shares of Rs. 10 each and 14,000 Equity shares of Rs. 2.50 each vide Board's Resolution dated...)			
Interest Payable on Debentures A/c	Dr.	12,800	
To Equity Share Capital A/c			5,000
To Capital Reduction A/c			7,800
(2,000 Equity shares of Rs. 2.50 each issued in full and final settlement of interest payable, balance credited to Capital Reduction Account vide Board's Resolution dated.....)			
8% Debentures A/c	Dr.	80,000	
To 9 ½% Debentures A/c			80,000
(8% Debentures converted into 9 ½% Debentures vide Board's Resolution dated.....)			
Bank A/c	Dr.	8,100	
Capital Reduction A/c	Dr.	900	
To 9 ½% Debentures A/c			9,000
(Rs. 9,000 Debentures issued at a discount of 10% for cash vide Board's Resolution dated.....)			
Loan from Directors A/c	Dr.	16,000	
To Capital Reduction A/c			6,000
To Equity Share Capital A/c			2,500
To Share Premium A/c			7,500
(Rs. 6,000 of directors' loan credited to Capital Reduction A/c, 1,000 Equity Shares of Rs. 2.50 each issued in settlement of the balance due. Rs. 7,500 credited to share premium A/c vide Board's Resolution dated...)			

Bank A/c	Dr.	60,000	
To Investment A/c			27,000
To Capital Reduction A/c			33,000
(Investment sold for Rs. 60,000, profit on sale credited to capital reduction A/c)			
Bank Overdraft (loan) A/c	Dr.	36,713	
Sundry Creditors A/c	Dr.	46,000	
To Bank A/c			82,713
(Payment of Bank overdraft Rs. 36,713 and Rs. 46,000 paid to sundry creditors)			
Building A/c	Dr.	52,754	
To Capital Reduction A/c			52,754
(Appreciation in the value of the building under the scheme of reconstruction dated.....)			
Capital Reduction A/c	Dr.	2,43,891	
To Goodwill			60,000
To Profit & Loss A/c			39,821
To Land			66,000
To Equipment			754
To Stock			70,247
To Sundry Debtors			7,069
(Amounts written off on various assets A/c and the amount of goodwill and debit balance of profit and loss account written off under scheme of reconstruction dated...)			

Working Note :

Capital Reduction Account

		Rs.			Rs.
To	Goodwill	60,000	By	Equity Share Capital A/c	1,50,000
”	Profit & Loss A/c	39,821	”	Debenture Interest	7,800

"	Sundry Debtors	7,069	"	Loan from Directors A/c	6,000
"	Land	66,000	"	Investment A/c	33,000
"	Equipment	754	"	Building	52,754
"	Stock	70,247			
"	Debentures (Discount)	900			
"	Capital Reserve	4,763			
		2,49,554			2,49,554

Balance Sheet of S.P. Construction Co. Ltd.

(And reduced) as on ......

Liabilities	*Rs.*	*Assets*		*Rs.*
Share Capital		Fixed Assets		
Issued, subscribed & paid up		Goodwill	60,000	
57,000 Equity shares of Rs. 2.50		*Less:* written off under		
each fully paid (17,000 shares issued	1,42,500	the scheme of Recons-		
on conversion and settlement		truction	60,000	—
of claims against the company)				
8% Cumulative Preference share capital	35,000	Land	1,56,000	
Reserve & surplus		*Less:* written off under		
Securities Premium	17,500	the scheme of Recons-		
Capital Reserve	4,763	truction	66,000	90,000
Secured Loans		Building	27,246	
9 ½% Debentures	89,000	Add Appreciation under		
Unsecured Loans		that Scheme of		
Current Liabilities		Reconstruction	52,754	80,000
& provisions		Equipment		
Sundry Creditors	50,247	less written off	10,754	
		Under the scheme		
		of reconstruction	754	10,000

		Investments	27,000	
		sold during the year	27,000	—
		Current Assets		
		Stock		50,000
		Sundry Debtors		
		(Rs. 7069 written off)		63,623
		Cash at Bank		45,387
	3,39,010			3,39,010

Illustration 3

The Balance Sheet of Revise Limited as at 31st March, 2006 was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Authorised and subscribed capital :		Fixed Assets :	
10,000 Equity shares of		Machineries	1,00,000
Rs. 100 each fully paid	10,00,000	Current assets :	
Unsecured Loans :		Stock	3,20,000
12% Debentures	2,00,000	Debtors	2,70,000
Accrued interest	24,000	Bank	30,000
Current liabilities - creditors	72,000	Profit and loss	
Provision for income tax	24,000	account	6,00,000
	13,20,000		13,20,000

It was decided to reconstruct the company for which necessary resolution was passed and sanctions were obtained from appropriate authorities. Accordingly, it was decided that :

(*a*) Each share be sub-divided into ten fully paid up equity shares of Rs. 10 each.

(*b*) After sub-division, each shareholder shall surrender to the company 50% of his holding, for the purpose of re-issue to debenture holders and creditors as necessary.

(*c*) Out of shares surrendered, 10,000 shares of Rs. 10 each shall be converted into 12% preference shares of Rs. 10 each fully paid up.

(*d*) The claims of the debenture-holders shall be reduced by 75 per cent. In consideration of the reduction, the debenture holders shall receive preference shares of Rs. 1,00,000 which are converted out of shares surrendered.

(*e*) Creditors claim shall be reduced to 50 per cent, it is to be settled by the issue of equity shares of Rs. 10 each out of shares surrendered.

(*f*) Balance of profit and loss account to be written off.

(*g*) The shares surrendered and not re-issued shall be cancelled.

You are required to show the journal entries giving effect to the above and the resultant Balance Sheet.

Solution :

		Dr.	Cr.
		Rs.	Rs.
Equity Share Capital (Rs. 100) A/c	Dr.	10,00,000	
To Share Surrender A/c			5,00,000
To Equity Share Capital (Rs. 10) A/c			5,00,000
(Subdivision of 10,000 equity shares of Rs. 100 each into 1,00,000 equity shares of Rs. 10 each and surrender of 50,000 of such subdivided shares as per capital reduction scheme)			
12% Debentures A/c	Dr.	1,50,000	
Accrued Interest A/c	Dr.	18,000	
To Reconstruction A/c			1,68,000
(Transferred 75% of the claims of the debentureholders to reconstruction account in consideration of which 12% preference shares are being issued out of share surrender account as per capital reduction scheme)			
Creditors A/c	Dr.	72,000	
To Reconstruction A/c			72,000
(Transferred claims of the creditors to reconstruction account, 50% of which is being clear reduction and equity shares are being issued in consideration of the balance)			

Share Surrender A/c	Dr.	5,00,000	
To 12% Preference Share Capital A/c			1,00,000
To Equity Share Capital A/c			36,000
To Reconstruction A/c			3,64,000
(Issued preference and equity shares to discharge the claims of the debenture holders and the creditors respectively as a per scheme and the balance in share surrender account is being transferred to reconstruction account)			
Reconstruction A/c	Dr.	6,04,000	
To Profit and Loss A/c			6,00,000
To Capital Reserve A/c			4,000
(Adjusted debit balance of profit and loss account against the reconstruction account and the balance in the latter is being transferred to capital reserve)			

Revise Limited (and reduced)

Balance Sheet as on...

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital :		Fixed Assets :	
Issued Capital :		Machineries	1,00,000
53,600 Equity Shares of Rs. 10 each	5,36,000	Current Assets, Loans and Advances :	
Preference Shares	1,00,000	(*A*) Current Assets :	
(Of the above shares all are allotted as fully paid up pursuant to capital reduction scheme by conversion of equity shares without payment being received in cash)		Stock	3,20,000
		Debtors	2,70,000
		Bank	30,000
		(*B*) Loans and Advances	nil

Reserve and Surplus :			
Capital Reserve	4,000		
Unsecured Loans :			
12% Debentures	50,000		
Accrued interest	6,000		
Current Liabilities and			
Provision for Income-tax	24,000		
	7,20,000		7,20,000

Illustration 4

The Balance Sheet of Y Limited as on 31st March, 2008 was as follows:

Liabilities	Amount (Rs.)	Assets	Amount (Rs.)
5,00,000 Equity Shares of Rs. 10 each fully paid	50,00,000	Goodwill	10,00,000
		Patent	5,00,000
9% 20,000 Preference shares of Rs. 100 each fully paid	20,00,000	Land and Building	30,00,000
		Plant and Machinery	10,00,000
10% First debentures	6,00,000	Furniture and Fixtures	2,00,000
10% Second debentures	10,00,000	Computers	3,00,000
Debentures interest outstanding	1,60,000	Trade Investment	5,00,000
Trade creditors	5,00,000	Debtors	5,00,000
Directors' loan	1,00,000	Stock	10,00,000
Bank O/D	1,00,000	Discount on issue of debentures	1,00,000
Outstanding liabilities	40,000		
Provision for Tax	1,00,000	Profit and Loss Account (Loss)	15,00,000
	96,00,000		96,00,000

Note: Preference dividend is in arrears for last three years.

A holds 10% first debentures for Rs. 4,00,000 and 10% second debentures for Rs. 6,00,000. He is also creditors for Rs. 1,00,000. B holds 10% first debentures for Rs. 2,00,000 and 10% second debentures for Rs. 4,00,000 and is also creditors for Rs. 50,000.

The following scheme of reconstruction has been agreed upon and duly approved by the court.

(i) All the equity shares be converted into fully paid equity shares of Rs. 5 each.

(ii) The preference shares be reduced to Rs. 50 each and the preference shareholders agree to forego their arrears of preference dividends in consideration of which 9% preference shares are to be converted into 10% preference shares.

(iii) Mr. 'A' is to cancel Rs. 6,00,000 of his total debt including interest on debentures and to pay Rs. 1 lakh to the company and to receive new 12% debentures for the Balance amount.

(iv) Mr. 'B' is to cancel Rs. 3,00,000 of his total debt including interest on debentures and to accept new 12% debentures for the balance amount.

(v) Trade creditors (other than A and B) agreed to forego 50% of their claim.

(vi) Directors to accept settlement of their loans as to 60% thereof by allotment of equity shares and balance being waived.

(vii) There were capital commitments totalling Rs. 3,00,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.

(viii) The Directors refund Rs. 1,10,000 of the fees previously received by them.

(ix) Reconstruction expenses paid Rs. 10,000.

(x) The taxation liability of the company is settled at Rs. 80,000 and the same is paid immediately.

(xi) The assets are revalued as under:

	Rs.
Land and Building	28,00,000
Plant and Machinery	4,00,000
Stock	7,00,000
Debtors	3,00,000

Computers	1,80,000
Furniture and Fixtures	1,00,000
Trade Investment	4,00,000

Pass Journal entries for all the above mentioned transactions including amounts to be written off of Goodwill, Patents, Loss in Profit & Loss Account and Discount on issue of debentures. Prepare Bank Account and working of allocation of Interest on Debentures between A and B.

Answer

Journal Entries in the Books of Y Ltd.

			Dr.	*Cr.*
			Rs.	*Rs.*
(i)	Equity Share Capital (Rs. 10 each) A/c	Dr.	50,00,000	
	To Equity Share Capital (Rs. 5 each) A/c			25,00,000
	To Reconstruction A/c			25,00,000
	(Being conversion of 5,00,000 equity shares of Rs. 10 each fully paid into same number of fully paid equity shares of Rs. 5 each as per scheme of reconstruction.)			
(ii)	9% Preference Share Capital (Rs.100 each) A/c	Dr.	20,00,000	
	To 10% Preference Share Capital (Rs.50 each) A/c			10,00,000
	To Reconstruction A/c			10,00,000
	(Being conversion of 9% preference share of Rs. 100 each into same number of 10% preference share of Rs. 50 each and claims of preference dividends settled as per scheme of reconstruction.)			

(iii)	10% First Debentures A/c	Dr. 4,00,000	
	10% Second Debentures A/c	Dr. 6,00,000	
	Trade Creditors A/c	Dr. 1,00,000	
	Interest on Debentures Outstanding A/c	Dr. 1,00,000	
	Bank A/c	Dr. 1,00,000	
	To 12% New Debentures A/c		7,00,000
	To Reconstruction A/c		6,00,000
	(Being Rs. 6,00,000 due to A (including creditors) cancelled and 12% new debentures allotted for balance amount as per scheme of reconstruction.)		
(iv)	10% First Debentures A/c	Dr. 2,00,000	
	10% Second Debentures A/c	Dr. 4,00,000	
	Trade Creditors A/c	Dr. 50,000	
	Interest on Debentures Outstanding A/c	Dr. 60,000	
	To 12% New Debentures A/c		4,10,000
	To Reconstruction A/c		3,00,000
	(Being Rs. 3,00,000 due to B (including creditors) cancelled and 12% new debentures allotted for balance amount as per scheme of reconstruction.)		
(v)	Trade Creditors A/c	Dr. 1,75,000	
	To Reconstruction A/c		1,75,000
	(Being remaining creditors sacrificed 50% of their claim.)		

(vi)	Directors' Loan A/c	Dr. 1,00,000	
	To Equity Share Capital (Rs. 5) A/c		60,000
	To Reconstruction A/c		40,000
	(Being Directors' loan claim settled by issuing 12,000 equity shares of Rs. 5 each as per scheme of reconstruction.)		
(vii)	Reconstruction A/c	Dr. 15,000	
	To Bank A/c		15,000
	(Being payment made for cancellation of capital commitments.)		
(viii)	Bank A/c	Dr. 1,10,000	
	To Reconstruction A/c		1,10,000
	(Being refund of fees by directors credited to reconstruction A/c.)		
(ix)	Reconstruction A/c	Dr . 10,000	
	To Bank A/c		10,000
	(Being payment of reconstruction expenses.)		
(x)	Provision for Tax A/c	Dr. 1,00,000	
	To Bank A/c		80,000
	To Reconstruction A/c		20,000
	(Being payment of tax for 80% of liability in full settlement.)		
(xi)	Reconstruction A/c	Dr. 47,20,000	
	To Goodwill A/c		10,00,000
	To Patent A/c		5,00,000
	To Profit and Loss A/c		15,00,000

To Discount on issue of Debentures A/c	1,00,000
To Land and Building A/c	2,00,000
To Plant and Machinery A/c	6,00,000
To Furniture & Fixture A/c	1,00,000
To Computers A/c	1,20,000
To Trade Investment A/c	1,00,000
To Stock A/c	3,00,000
To Debtors A/c	2,00,000
(Being writing off of losses and reduction in the value of assets as per scheme of reconstruction.)	

Working Notes:

(1) Outstanding interest on debentures have been allocated between A and B as follows:

			Rs.
A's Share			
10% First Debentures	4,00,000		
10% Second Debentures	6,00,000	10,00,000	
10% on Rs. 10,00,000 i.e.			1,00,000
B's Share			
10% First Debentures	2,00,000		
10% Second Debentures	4,00,000	6,00,000	
10% on Rs. 6,00,000 i.e.			60,000
		Total	1,60,000

(2) **Bank Account**

		Rs.			Rs.
To	A (reconstruction)	1,00,000	By	Balance b/d	1,00,000
To	Reconstruction A/c		By	Reconstruction A/c	15,000

(paid by directors)	1,10,000		(capital commitment penalty paid)	
		By	Reconstruction A/c (reconstruction expenses paid)	10,000
		By	Provision for tax A/c(tax paid)	80,000
		By	Balance c/d	5,000
	2,10,000			2,10,000

Illustration 5

Following are the summarised Balance Sheets of A Ltd. and B Ltd. as at 31.3.2008:

Particulars	A Ltd.	B Ltd.
Share capital: Equity shares 10 each (fully paid up)	10,00,000	6,00,000
Securities premium	2,00,000	----
General reserve	3,00,000	2,50,000
Profit and loss account	1,80,000	1,60,000
10% Debentures	5,00,000	----
Secured loan	-----	3,00,000
Sundry creditors	2,60,000	1,70,000
	24,40,000	14,80,000
Land and building	9,00,000	4,50,000
Plant and machinery	5,00,000	3,80,000
Investment (5,000 shares of B Ltd.)	80,000	----
Stock	5,20,000	3,50,000
Debtors	4,10,000	2,60,000
Cash at bank	30,000	40,000
	24,40,000	14,80,000

The companies agree on a scheme of amalgamation on the following terms:

(i) A new company is to be formed by name AB Ltd.

(ii) AB Ltd. to take over all the assets and liabilities of the existing companies.

(iii) For the purpose of amalgamation, the shares of the existing companies are to be valued as under:

A Ltd. = Rs.18 per share

B Ltd. = Rs.20 per share

(iv) A contingent liability of A Ltd. of Rs.60,000 is to be treated as actual existing liability.

(v) The shareholders of A Ltd. and B Ltd. are to be paid by issuing sufficient number of shares of AB Ltd. at a premium of Rs.6 per share.

(vi) The face value of shares of AB Ltd. are to be of Rs.10 each.

You are required to:

(i) Calculate the purchase consideration (i.e., number of shares to be issued to A Ltd. and B Ltd.).

(ii) Pass journal entries in the books of A Ltd. for the transfer of assets and liabilities.

(iii) Pass journal entries in the books of AB Ltd. for acquisition of A Ltd. and B Ltd.

(iv) Prepare the Balance Sheet of AB Ltd.

Answer

(i) Statement showing calculation of purchase consideration

		(Number of shares)
	A Ltd.	*B. Ltd.*
Existing shares	1,00,000	60,000
Less: Shares held by A Ltd.	______	5,000
	1,00,000	55,000
Value per share	Rs.18	Rs.20
Total value	Rs.18,00,000	Rs.11,00,000
No. of shares to be issued at a premium of Rs.6 per share i.e. Rs.16 (10+6)	1,12,500 shares	68,750 shares

	Rs.	Rs.
Share capital	11,25,000	6,87,500
Add: Securities premium	6,75,000	4,12,500
Total purchase consideration	18,00,000	11,00,000

(ii) Journal Entries in the books of A Ltd.

		Rs.	Rs.
Realisation A/c	Dr.	24,40,000	
To Land & building			9,00,000
To Plant & machinery			5,00,000
To Stock			5,20,000
To Sundry debtors			4,10,000
To Investmenst			80,000
To Bank			30,000
(Being assets transferred to Realisation A/c)			
Profit and loss A/c	Dr.	60,000	
To Creditors			60,000
(Being contingent liability treated as real liability)			
10% Debentures A/c	Dr.	5,00,000	
Creditors A/c	Dr.	3,20,000	
To Realisation A/c			8,20,000
(Being transfer of liabilities to Realisation A/c)			
AB Ltd.	Dr.	18,00,000	
To Realisation A/c			18,00,000
(Being the purchase consideration accounted for)			

Share in AB Ltd. A/c	Dr.	18,00,000	
To AB Ltd.			18,00,000
(Being purchase consideration received)			
Share Capital A/c	Dr.	10,00,000	
Securities premium A/c	Dr.	2,00,000	
General Reserve A/c	Dr.	3,00,000	
Profit and Loss A/c	Dr.	1,20,000	
Realisation A/c	Dr.	1,80,000	
To Shareholders A/c			18,00,000
(Being transfer of balances to shareholders' account)			
Shareholders A/c	Dr.	18,00,000	
To Shares in AB Ltd.			18,00,000
(Being closure of shareholders a/c)			

(iii) Journal Entries in the Books of AB Ltd.

		Rs.	Rs.
Land & building A/c	Dr.	9,00,000	
Plant & machinery A/c	Dr.	5,00,000	
Stock	Dr.	5,20,000	
Debtors	Dr.	4,10,000	
Bank	Dr.	30,000	
Goodwill	Dr.	2,60,000	
To 10% Debentures			5,00,000
To Sundry creditors			3,20,000
To Liquidator of A Ltd.			18,00,000
(Being the purchase consideration of A Ltd. accounted for)			

Land & building A/c	Dr.	4,50,000	
Plant & machinery A/c	Dr.	3,80,000	
Stock A/c	Dr.	3,50,000	
Debtors A/c	Dr.	2,60,000	
Bank A/c	Dr.	40,000	
Goodwill A/c	Dr.	90,000	
To Secured loan A/c			3,00,000
To Sundry creditors			1,70,000
To Liquidator of B Ltd.			11,00,000
(Being purchase consideration of B Ltd. accounted for)			
Liquidator of A Ltd.	Dr.	18,00,000	
To Equity share capital			11,25,000
To Securities premium			6,75,000
(Being shares issued to Liquidator of A Ltd.)			
Liquidator of B Ltd. A/c	Dr.	11,00,000	
To Equity share capital			6,87,500
To Securities premium			4,12,500
(Being shares issued to Liquidator of B Ltd.)			

(iv)

Balance Sheet of AB Ltd.

(After amalgamation of A Ltd. & B Ltd.)

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital:		Goodwill (2,60,000 + 90,000)	3,50,000
1,81,250 Equity shares of Rs.10 each fully paid up	18,12,500	Land & building	13,50,000
(above shares have been issued for consideration other than cash)		Plant & machinery Stock	8,80,000 8,70,000

Securities premium	10,87,500	Sundry debtors	6,70,000
10% Debentures	5,00,000	Cash at bank	70,000
Secured loan	3,00,000		
Sundry creditors	4,90,000		
	41,90,000		41,90,000

Illustration 6

A Ltd. agreed to acquire the business of B Ltd. as on 31st December, 2007. On that date

Balance Sheet of B Ltd. was summarized as follows:

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital (Fully paid		Goodwill	50,000
shares of Rs. 10 each)	3,00,000	Land, Building	
General Reserve	85,000	and Plant	3,20,000
P & L A/c	55,000	Stock-in-trade	84,000
6% Debentures	50,000	Debtors	18,000
Creditors	10,000	Cash & Bank Balance	28,000
	5,00,000		5,00,000

The Debenture holders agreed to receive such 7% Debentures issued as 96 each as would discharge the debentures in B Ltd. at a premium of 20%. The shareholders in B Ltd. were to receive Rs. 2.50 in cash per share and 3 shares in A Ltd. for every two shares held – the shares in A Ltd. being considered as worth Rs. 12.50 each.

There were fractions equaling 50 shares for which each was paid. The directors of A Ltd. considered the various assets to be valued as follows:

	Rs.
Land	1,00,000
Buildings	2,50,000
Plant	3,50,000
Stock	80,000
Debtors	18,000

The cost of liquidation of B Ltd. ultimately was Rs. 5,000. Due to a technical hitch, the transaction could be completed only on 1st July, 2008. Till date B Ltd. carried on trading which resulted in a profit Rs. 20,000 (subject to interest) after providing Rs. 15,000 as depreciation. On 30th June, 2008 Stock was Rs. 90,000. Debtors were Rs. 25,000 and Creditors were Rs. 15,000. There was no addition to or deletion from the fixed assets. It was agreed that the profit should belong to A Ltd.

You are required, as on July 1, 2008, to:

(*i*) prepare Realisation Account and the Shareholders Account in the ledger of B Ltd., and

(*ii*) give journal entries in the books of A Ltd.

Solution:

LEDGER OF B LTD.

Realisation A/c

		Dr. Rs.			*Cr.* Rs.
To	Sundry Assets, transfer :		By	Sundry Creditors	15,000
	Goodwill	50,000	By	6% Debentures	50,000
	Land, Building, Plant, etc.,	3,20,000	By	A Ltd. - purchase consideration (2)	6,37,500
To	Stock-in-trade	90,000			
To	Debtors	25,000	By	Provision for Depreciation	15,000
To	Cash & Bank Balance (1)	55,000	By	A Ltd. [for profit (3)]	20,000
To	Shareholders - profit	1,97,500			
		7,37,500			7,37,500

Shareholders Account

To	Cash	75,625	By	Share Capital A/c - transfer	3,00,000
To	Shares in A Ltd.	5,61,875	By	General Reserve	85,000
			By	P & L A/c	55,000
			By	Realisation A/c	1,97,500
		6,37,500			6,37,500

Note : It is clear that the costs of liquidation will be payable by A Ltd. since the amount payable to the shareholders has been specified.

			Rs.	Rs.
(1)	Cash and Bank Balances as on Jan. 1, 2008			28,000
	Add: Profit earned			20,000
	Depreciation provided (no cash payment)			15,000
	Increase in Sundry Creditors			5,000
				68,000
	Less: Increase in Stock		6,000	
	Increase in Debtors		7,000	13,000
				55,000
(2)	Purchase Consideration:			
	For Shareholders	— Cash 30,000 × Rs. 2.50		75,000
		— Shares 30,000 × 3/2 – 50 = 44,950 @ Rs. 12.5		5,61,875
		— Cash for fractions of shares 50 @ Rs. 12.50		625
				6,37,500
(3)	Since the transfer of assets is as on 30th June, 2008, the profit of Rs. 20,000 must be standing to the credit of A Ltd.			

Journal of A Ltd.

2008			Dr.	Cr.
July 1	Business Purchase Account	Dr.	6,37,500	
	To Liquidator of B Ltd.			6,37,500
	(Purchase consideration settled as per agreement dated... for the business of B Ltd.)			
	Land A/c	Dr.	1,00,000	
	Buildings A/c	Dr.	2,50,000	
	Plant A/c	Dr.	3,50,000	
	Stock A/c	Dr.	86,000	
	Sundry Debtors A/c	Dr.	25,000	
	Bank A/c	Dr.	55,000	

To Provision for Depreciation A/c			15,000
To Profit & Loss Suspense A/c			20,000
To Sundry Creditors A/c			15,000
To Business Purchase A/c			6,37,500
To Liability for Debentures in B Ltd			60,000
To Capital Reserve A/c			1,18,500
(Various assets and liabilities taken over from B Ltd. – profit up to June 30, 2008 being credited to P & L Suspense A/c since it is to be adjusted for interest and additional depreciation due to increase in values of assets)			
Capital Reserve A/c	Dr.	5,000	
To Cash A/c			5,000
(Expenses of Liquidation paid by A Ltd.)			
Liquidator of B Ltd.	Dr.	6,37,500	
To Cash A/c			75,625
To Share Capital A/c			4,49,500
To Securities Premium A/c			1,12,375
(Discharge of the purchase consideration as per agreement)			
Liability for Debentures in B Ltd. A/c	Dr.	60,000	
Discount on issue of debentures A/c	Dr.	2,500	
To 7% Debentures A/c			62,500
(Discharge of debenture holders of B Ltd.			

Note : (1) Debentures are issued at Rs. 96. Hence the nominal value is $60{,}000 \times \frac{100}{96}$ or Rs. 62,500; Rs. 2,500 is, therefore, debited to the Discount on Issue of Debentures Account.

(2) It is assumed that the reduction in the value of the stock as on Jan. 1, 2008 still applies.

Illustration 7

Star and Moon had been carrying on business independently. They agreed to amalgamate and form a new company Neptune Ltd. with an authorised share capital of Rs. 2,00,000 divided into 40,000 equity shares of Rs. 5 each.

On 31st December, 2007, the respective Balance Sheets of Star and Moon were as follows :

	Star	*Moon*
	Rs.	*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
Representing Capital	1,82,500	1,76,250

Additional Information :

(a) Revalued figures of Fixed and Current Assets were as follows :

	Star	*Moon*
	Rs.	*Rs.*
Fixed Assets	3,55,000	1,95,000
Current Assets	1,49,750	78,875

(b) The debtors and creditors—include Rs. 21,675 owed by Star to Moon.

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

(i) 30,000 equity shares of Neptune Ltd., to Star and Moon 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 :

	Star	*Moon*
2005 Profit	2,24,788	1,36,950
2006 (Loss)/Profit	(1,250)	1,71,050
2007 Profit	1,88,962	1,79,500

(ii) 15% debentures in Neptune Ltd., at par to provide an income equivalent to 8% return on capital employed in their respective business as on 31st December, 2007 after revaluation of assets.

You are requested to :

(1) Compute the amount of debentures and shares to be issued to Star and Moon.

(2) A Balance Sheet of Neptune Ltd., showing the position immediately after amalgamation.

Solution

(1) **Computation of Amount of Debentures and Shares to be issued:**

		Star	Moon
		Rs.	*Rs.*
(i) *Average Net Profit*			
$\frac{2,24,788 - 1,250 + 1,88,962}{3}$	=	1,37,500	
$\frac{1,36,950 + 1,71,050 + 1,79,500}{3}$	=		1,62,500
(ii) *Equity Shares Issued*			
(a) Ratio of distribution			
Star : Moon			
1,375 : 1,625			
(b) Number			
Star : 13,750			
Moon : 16,250			
30,000			
(c) Amount			
13,750 shares of Rs. 5 each	=	68,750	
16,250 shares of Rs. 5 each	=		81,250
(iii) *Capital Employed (after revaluation of assets)*			
Fixed Assets		3,55,000	1,95,000
Current Assets		1,49,750	78,875
		5,04,750	2,73,875

Less: Current Liabilities	2,98,500	90,125
	2,06,250	1,83,750

(iv) *Debentures Issued*

8% Return on capital employed	16,500	14,700

15% Debentures to be issued to provide equivalent income :

Star : $16,500 \times \frac{100}{15}$ = 1,10,000

Moon : $14,700 \times \frac{100}{15}$ = 98,000

(2)

Balance Sheet of Neptune Ltd.

As at 31st December, 2007

Liabilities	*Amount* *Rs.*	*Assets*	*Amount* *Rs.*
Share Capital:		Fixed Assets	5,50,000
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	1,50,000		
(all the above shares are allotted as fully paid-up pursuant to a contract without payments being received in cash)			
Reserves and Surplus			
Capital Reserve	32,000		
Secured Loans			
15% Debentures	2,08,000		
Unsecured Loans	–		

Current Liabilities and Provisions		
Current Liabilties	3,66,950	
Provisions	–	
	7,56,950	7,56,950

Working Notes :

	Star Rs.	*Moon* Rs.	*Total* Rs.
(1) *Purchase Consideration*			
Equity Shares Issued	68,750	81,250	1,50,000
15% Debentures Issued	1,10,000	98,000	2,08,000
	1,78,750	1,79,250	3,58,000
(2) *Capital Reserve*			
(a) Net Assets Taken Over			
Fixed Assets	3,55,000	1,95,000	5,50,000
Current Assets	1,49,750	57,200*	2,06,950
	5,04,750	2,52,200	7,56,950
Less : Current Liabilities	2,76,825**	90,125	3,66,950
	2,27,925	1,62,075	3,90,000
(b) Purchase Consideration	1,78,750	1,79,250	3,58,000
(c) Capital Reserve [(a) - (b)]	49,175		
(d) Goodwill [(b) - (a)]		17,175	
(e) Capital Reserve [Final Figure(c) - (d)]			32,000

* 78, 875 - 21,675

** 2,98,500 - 21,675

Illustration 8

P and Q have been carrying on same business independently. Due to competition in the market, they decided to amalgamate and form a new company called PQ Ltd.

Following is the Balance Sheet of P and Q as at 31.3.2007:

Liabilities	*P*	*Q*	*Assets*	*P*	*Q*
	Rs.	*Rs.*		*Rs.*	*Rs.*
Capital	7,75,000	8,55,000	Plant & machinery	4,85,000	6,14,000
Current liabilities	6,23,500	5,57,600	Building	7,50,000	6,40,000
			Current assets	1,63,500	1,58,600
	13,98,500	14,12,600		13,98,500	14,12,600

Following are the additional information:

(i) The authorised capital of the new company will be Rs.25,00,000 divided into 1,00,000 equity shares of Rs.25 each.

(ii) Liabilities of P includes Rs.50,000 due to Q for the purchases made. Q made a profit of 20% on sale to P.

(iii) P has goods purchased from Q, cost to him Rs.10,000. This is included in the Current asset of P as at 31st March, 2007.

(iv) The assets of P and Q are to be revalued as under:

	P	*Q*
	Rs.	*Rs.*
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000

(v) The purchase consideration is to be discharged as under:

(a) Issue 24,000 equity shares of Rs. 25 each fully paid up in the proportion of their profitability in the preceding 2 years.

(b) Profits for the preceding 2 years are given below:

	P	Q
	Rs.	Rs.
1st year	2,62,800	2,75,125
IInd year	2,12,200	2,49,875
Total	4,75,000	5,25,000

(c) Issue 12% preference shares of Rs.10 each fully paid up at par to provide income equivalent to 8% return on capital employed in the business as on 31.3.2007 after revaluation of assets of P and Q respectively.

You are required to:

(i) Compute the amount of equity and preference shares issued to P and Q.

(ii) Prepare the Balance Sheet of P & Q Ltd. immediately after amalgamation.

Answer

(i) **Calculation of amount of equity shares issued to P and Q**

Profits of	*P*	*Q*
	Rs.	*Rs.*
Ist year	2,62,800	2,75,125
IInd year	2,12,200	2,49,875
Total	4,75,000	5,25,000

No. of shares to be issued = 24,000 equity shares in the proportion of the preceding 2 years' profitability

24000 x 475/1000	11,400 equity shares	
24000 x 525/1000		12,600 equity shares

Calculation of amount of 12% Preference shares issued to P and Q

	P	*Q*
	Rs.	*Rs.*
Capital employed (Refer working note 1)	8,40,000	9,24,000
8% return on capital employed	67,200	73,920
12% Preference shares to be issued $\left[67{,}200\times\frac{100}{12}\right]$	Rs. 5,60,000	
$\left[73{,}920\times\frac{100}{12}\right]$		Rs. 6,16,000

Total Purchase Consideration

	P	Q
	Rs.	*Rs.*
Equity Shares	2,85,000	3,15,000
12% Preference shares	5,60,000	6,16,000
Total	8,45,000	9,31,000

(ii) **Balance Sheet of PQ Ltd. (after amalgamation)**

Liabilities	*Rs.*	*Assets*	*Rs.*
Authorised share capital:		*Fixed assets:*	
1,00,000 Equity Share of Rs.25 each	25,00,000	Goodwill (W.N.1)	14,000
Issued and subscribed share capital:		Plant and Machinery	12,00,000
24,000 Equity Shares of Rs.25 each	6,00,000	Building	14,23,000
1,17,600 12% Preference shares of Rs.10 each	11,76,000	*Current Assets* (W.N.2)	2,70,100
(All of the equity and preference shares have been issued for consideration other than cash)			
Current Liabilities (W.N. 3)	11,31,100		
	29,07,100		29,07,100

Working Notes:

1. Goodwill

	P	Q
	Rs.	*Rs.*
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000
Current assets	1,63,500	1,58,600
	14,63,500	14,81,600
Less: Current liabilities	6,23,500	5,57,600
Net assets taken (capital employed)	8,40,000	9,24,000
Less: Purchase consideration	8,45,000	9,31,000
Goodwill	5,000	7,000
Total purchased goodwill		12,000
Add: Unrealised profit of Rs.10,000 @ 20% = Rs.2,000 is adjusted from current assets and from goodwill (since P & L A/c is not given)		2,000
Total Goodwill		14,000

2. Current Assets

	P	Q
	Rs.	*Rs.*
Balances before amalgamation	1,63,500	1,58,600
Less: Liabilities of P due to Q	-	50,000
Less: Unrealised Profit on stock i.e.Rs.10,000 x 20%	2,000	
Total	1,61,500	1,08,600
Grand Total		2,70,100

3. Current Liabilities

	P	Q
	Rs.	*Rs.*
Balances before amalgamation	6,23,500	5,57,600
Less: Liabilities of P due to Q	50,000	-
Total	5,73,500	5,57,600
Grand Total		11,31,100

Illustration 9

X Ltd. and Y Ltd. were amalgamated on and from 1st April, 2007 and formed a new company Z Ltd. to takeover the business of X Ltd. and Y Ltd. The Balance Sheets of X Ltd. and Y Ltd., as on 31st March, 2007 are as follows:

(Rs. in Crores)

Liabilities	***X Ltd.***	***Y Ltd.***	***Assets***	***X Ltd.***	***Y Ltd.***
Share Capital:			Land and Buildings	38	25
Equity share of Rs.10 each	50	45	Plant and Machinery	24	17
10% Preference shares of Rs.100 each	20	14	Investments	10	6
Revaluation Reserve	10	6	Stock	22	15
General Reserve	12	8	Sundry Debtors	25	20
Investment Allowance	5	4	Bills Receivable	5	4
Reserve			Cash at Bank	16	13
Profit & Loss Account	8	6			
15% Debentures of Rs.100 each (Secured)	4	5			

Sundry Creditors	19	7			
Bills Payable	12	5			
	140	100		140	100

Additional Information:

(1) Z Ltd. will issue 6 equity shares for 10 equity shares of X Ltd. and 2 equity shares for 5 equity shares of B Ltd. The shares are issued @ Rs.30 each having a face value of Rs.10 per share.

(2) Preference shareholders of two companies are issued equivalent number of 15% preference shares of Z Ltd. at a price of Rs.120 per share (face value Rs.100).

(3) 15% Debentureholders of X Ltd. and Y Ltd. are discharged by Z Ltd. issuing such number of its 18% Debentures of Rs.100 each so as to maintain the same amount of interest.

(4) Investment allowance reserve is to be maintained for 4 more years. Prepare the Balance Sheet of Z Ltd. after amalgamation. The amalgamation took place in the nature of purchase.

Solution

Balance Sheet of Z Ltd. As at 1st April, 2007 ***(Rs. in crores)***

Liabilities	***Amount***	***Assets***	***Amount***
Share Capital		**Fixed Assets**	
4,80,00,000 Equity shares of Rs.10 each	48.00	Land and Buildings	63.00
34,00,000 15% Preference Shares of Rs.100 each	34.00	Plant and Machinery	41.00
(all the above shares are allotted as fully paid up pursuant to contracts without payment being received in cash)		**Investments**	16.00
Reserves and Surplus		**Current Assets, Loans and Advances**	
Security Premium (60 + 36 + 4 + 2.8)	102.80	A. Current Assets	
Capital Reserve (W.N.4)	4.70	Stock	37.00

Investment Allowance Reserve	9.00	Sundry Debtors	45.00
Secured Loans		Cash at Bank	29.00
18% of Debentures (Rs.100 each)	7.50	***B. Loans and Advances***	
Unsecured Loans		Bills Receivable	9.00
Current Liabilities and Provisions		**Miscellaneous Expenditure**	
Sundry Creditors	26.00	(to the extent not written off or adjusted)	
Bills Payable	17.00	Amalgamation Adjustment Account	9.00
	249.00		249.00

Note: Since Investment Allowance Reserve is to be maintained for 4 years, it is carried forward by a corresponding debit to Amalgamation Adjustment Account in accordance with AS-14.

Working Notes:

1. Calculation of Net assets taken over *(Rs. In crores)*

Particulars		X Ltd.	Y Ltd.
Assets taken over:			
Land and Buildings		38	25
Plant and Machinery		24	17
Investments		10	6
Stock		22	15
Sundry Debtors		25	20
Bills Receivable		5	4
Cash at Bank		16	13
	(i)	140	100
Liabilities taken over:			
Debentures		3.33	4.17

Sundry Creditors		19.00	7.00
Bills Payable		12.00	5.00
	(ii)	34.33	16.17
Net assets taken over	(i) – (ii)	105.67	83.83

2. Calculation of No. of Debentures to be issued in Z Ltd.

X Ltd.

Existing Debenture interest @ 15% = Rs.400 lakhs x 15/100 = Rs.60 lakhs

Debentures to be issued in Z Ltd. @ 18% to maintain the same amount of interest

= Rs.60 lakhs x 100/18 = Rs.333.33 lakhs or Rs.3.33 crores

Y Ltd.

Existing Debenture interest @15% = Rs.500 lakhs x 15/100 = Rs.75 lakhs

Debentures to be issued in Z Ltd. @ 18% to maintain the same amount of interest

= Rs.75 x 100/18 = Rs.416.67 lakhs

or Rs.4.17 crores

3. Computation of Purchase Consideration: ***(Rs. In crores)***

	X Ltd.	***Y Ltd.***
1. Equity Shareholders		
$\frac{\text{Rs.50 crores}}{\text{Rs.10}} \times \frac{6}{10} \times \text{Rs.30}$	90	
$\frac{\text{Rs.45 crores}}{\text{Rs.10}} \times \frac{2}{5} \times \text{Rs.30}$		54

2. Preference Shareholders

$\frac{\text{Rs.20 crores}}{\text{Rs.100}} \times \text{Rs.120}$	24	
$\frac{\text{Rs.14 crores}}{\text{Rs.100}} \times \text{Rs.120}$	____	16.8
Total Purchase consideration	114	70.8

4. Calculation of Goodwill/Capital Reserve (Rs. in crores)

Particulars	X Ltd.	Y Ltd.
Net Assets takeover	105.67	83.83
Less: Purchase Consideration	114.00	70.80
Goodwill	8.33	----
Capital Reserve	---	13.03

Note: Goodwill arising from amalgamation shall be adjusted against capital Reserve arising from amalgamation, and only balance of Rs.4.70 crores is to be shown in the Balance Sheet of Z Ltd as capital reserve.

Illustration 10

The Balance Sheet of A Limited and B Limited as at 31st March, 2008 are as follows:

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Equity share of Rs.10 each	20,00,000	12,00,000	Sundry assets	30,00,000	14,00,000
General reserve	4,00,000	2,20,000	40,000 Equity shares in A Ltd.	-	4,00,000
Creditors	6,00,000	3,80,000			
	30,00,000	18,00,000		30,00,000	18,00,000

A Ltd. absorbed B Ltd. on the basis of intrinsic value of the shares. The purchase consideration is to be discharged in fully paid-up equity shares. A sum of Rs.1,00,000 is owed by A Ltd. to B Ltd., also included in the stock of A Ltd. is Rs.1,20,000 goods supplied by B Ltd. at cost plus 20%.

Give Journal entries in the books of both the companies, if entries are made at intrinsic value. Also prepare Balance Sheet of A Ltd. after absorption.

Answer

In the Books of B Ltd.

Journal Entries

			Dr. (Rs.)	*Cr. (Rs.)*
(i)	Realisation A/c	Dr.	14,00,000	
	To Sundry assets A/c			14,00,000
	(Being assets transferred to realization account on sale of business to A Ltd.)			
(ii)	Creditors A/c	Dr.	3,80,000	
	To Realisation A/c			3,80,000
	(Being creditors transferred to realization account on sale of business to A Ltd.)			
(iii)	Equity share capital A/c	Dr.	12,00,000	
	General reserve A/c	Dr.	2,20,000	
	To Equity shareholders A/c			14,20,000
	(Being transfer of share capital and general reserve to shareholders account)			
(iv)	A Ltd.	Dr.	10,20,000	
	To Realisation A/c			10,20,000
	(Being purchase consideration due – W.N. 2)			
(v)	Equity shares in A Ltd.	Dr.	10,20,000	
	To A Ltd.			10,20,000
	(Being purchase consideration received by A Ltd.)			
(vi)	Equity shares in A Ltd. A/c	Dr.	80,000	
	To Realisation A/c			80,000
	(Being appreciation in the value of shares of A Ltd. brought into books as entries are to be made at intrinsic value)			

(vii)	Realisation A/c	Dr.	80,000	
	To Equity shareholders A/c			80,000
	(Being profit on realization transferred to shareholders account)			
(viii)	Equity shareholders A/c	Dr.	15,00,000	
	To Equity shares in A Ltd. A/c			15,00,000
	(Being 85,000+ 40,000 = 1,25,000 shares distributed to equity shareholders of B Ltd.)			

Journal Entries In the Books of A Ltd.

			Dr. (Rs.)	*Cr. (Rs.)*
(i)	Business purchase A/c	Dr.	10,20,000	
	To Liquidators of B Ltd. A/c			10,20,000
	(Being amount payable to B Ltd. – W.N. 2)			
(ii)	Sundry assets A/c	Dr.	14,00,000	
	To Creditors A/c			3,80,000
	To Business purchase A/c			10,20,000
	(Being assets & liabilities taken over and purchase consideration due)			
(iii)	Liquidators of B Ltd. A/c	Dr.	10,20,000	
	To Equity share capital A/c			8,50,000
	To Securities premium A/c			1,70,000
	(Being shares allotted in full payment of purchase consideration)			

(iv)	Creditors A/c	Dr.	1,00,000	
	To Debtors (of B Ltd.) A/c			1,00,000
	(Being cancellation of mutual liability of debtors & creditors of Rs.1,00,000)			
(v)	General reserve A/c	Dr.	20,000*	
	To Stock A/c			20,000
	(Being elimination of unrealized profit on unsold stock of Rs.1,20,000, bought from B Ltd.)			

*Unrealized profit = Rs.1,20,000 × 20/120 = Rs.20,000.

Balance Sheet of A Ltd.

as at 31st March, 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Share capital:		Sundry assets	42,80,000
2,85,000 Equity shares of Rs.10 each	28,50,000	(30,00,000 + 14,00,000 – 1,00,000 – 20,000)	
(of the above, 85,000 equity shares of Rs.10 each are issued for consideration other than cash)			
Securities premium	1,70,000		
General reserve	3,80,000		
Creditors	8,80,000		
(6,00,000 + 3,80,000- 1,00,000)			
	42,80,000		42,80,000

Working Notes:

1. Calculation of Intrinsic Value of shares of 'A' Ltd.

	Rs.
Sundry assets of A Ltd.	30,00,000
Less: Creditors	6,00,000
Net assets	24,00,000
Number of equity shares	2,00,000 shares
Intrinsic value per equity share = $\frac{\text{Rs.}24,00,000}{2,00,000 \text{ shares}}$	Rs. 12 per share

2. Calculation of Purchase Consideration

Sundry assets of B Ltd.	14,00,000
Add: Investments in shares of A Ltd. (40,000 shares × Rs.12)	4,80,000
	18,80,000
Less: Creditors	3,80,000
Net assets	15,00,000
	Shares
Total number of equity shares to be issued by A Ltd. @Rs.12 per share (Rs.15,00,000 / Rs.12)	1,25,000
Less: Number of equity shares of A Ltd. which are already with B Ltd.	40,000
Number of shares to be issued to outsiders	85,000
	Rs.
Equity share capital (85,000 shares × Rs.10)	8,50,000
Securities premium (85,000 shares × Rs.2)	1,70,000
Purchase consideration	10,20,000

Self-Examination Questions

1. Green Limited had decided to reconstruct the Balance Sheet since it has accumulated huge losses. The following is the Balance Sheet of the Company on 31.3.2008 before reconstruction :

Balance Sheet of Green Limited as at 31.3.2008

Liabilities	**Rs.**	**Assets**	**Rs.**
Share Capital:		Fixed Assets:	
Authorised:		Goodwill	20,00,000
1,50,000 Equity Shares of Rs. 50 each	75,00,000	Building	10,00,000
Subscribed and Paid up Capital:		Plant	10,00,000
50,000 Equity Shares of Rs. 50 each	25,00,000	Computers	25,00,000
1,00,000 Equity Shares of Rs. 50 each,		Investments	Nil
Rs. 40 per share paid up	40,00,000	Current Assets	Nil
Secured Loans:		Profit and Loss A/c—Loss	20,00,000
12% First Debentures	5,00,000		
12% Second Debentures	10,00,000		
Current Liabilities:			
Sundry Creditors	5,00,000		
	85,00,000		85,00,000

The following is the interest of Mr. X and Mr. Y in Green Limited:

	Mr. X	Mr. Y
	Rs.	Rs.
12% First Debentures	3,00,000	2,00,000
12% Second Debentures	7,00,000	3,00,000
Sundry Creditors	2,00,000	1,00,000
	12,00,000	6,00,000
Fully paid up Rs. 50 shares	3,00,000	2,00,000
Parly paid up shares (Rs. 40 paid up)	5,00,000	5,00,000

The following Scheme of Reconstruction is approved by all parties interested and also by the Court:

(a) Uncalled capital is to be called up in full and such shares and the other fully paid up shares be converted into equity shares of Rs. 20 each.

(b) Mr. X is to cancel Rs. 7,00,000 of his total debt (other than share amount) and to pay Rs. 2 lakhs to the company and to receive new 14% First Debentures for the balance amount.

(c) Mr. Y is to cancel Rs. 3,00,000 of his total debt (other than equity shares) and to accept new 14% First Debentures for the balance.

(d) The amount thus rendered available by the scheme shall be utilised in writing off of Goodwill, Profit and Loss A/c Loss and the balance to write off the value of computers.

You are required to draw the Journal Entires to record the same and also show the Balance Sheet of the reconstructed company.

2. The following is the Balance Sheet of Rocky Ltd. as at March 31, 2008:

Liabilities	Rs. in lacs
Fully paid equity shares of Rs. 10 each	500
Capital Reserve	6
12% Debentures	400
Debenture Interest Outstanding	48
Trade Creditors	165
Directors' Remuneration Outstanding	10
Other Outstanding Expenses	11
Provisions	33
	1,173
Assets	
Goodwill	15
Land and Building	184
Plant and Machinery	286
Furniture and Fixtures	41
Stock	142

Debtors	80
Cash at Bank	27
Discount on Issue of Debentures	8
Profits and Loss Account	390
	1,173

The following scheme of internal reconstruction was framed, approved by the Court, all the concerned parties and implemented:

(i) All the equity shares be converted into the same number of fully-paid equity shares of Rs. 2.50 each.

(ii) Directors agree to forego their outstanding remuneration.

(iii) The debenture holders also agree to forego outstanding interest in return of their 12% debentures being converted into 13% debentures.

(iv) The existing shareholders agree to subscribe for cash, fully paid equity shares of Rs. 2.50 each for Rs. 125 lacs.

(v) Trade creditors are given the option of either to accept fully-paid equity shares of Rs. 2.50 each for the amount due to them or to accept 80% of the amount due in cash. Creditors for Rs. 65 lacs accept equity shares whereas those for Rs. 100 lacs accept Rs. 80 lacs in cash in full settlement.

(vi) The Assets are revalued as under :

	Rs. in lacs
Land and building	230
Plant and Machinery	220
Stock	120
Debtors	76

Pass Journal Entries for all the above mentioned transactions and draft the company's Balance Sheet immediately after the reconstruction.

3. Given below is the balance sheet of S Ltd. as on 31st March, 2007:

(Amount in lakhs of rupees)

Equity share capital (in equity shares of Rs. 10 each)	4.00	Block of assets less depreciation to date	6.00

10% Preference share capital	3.00	Stock and debtors	5.30
General Reserve	1.00	Cash and bank	0.70
Profit and Loss account	1.00		
Creditors	3.00		
	12.00		12.00

A Ltd., another existing company holds 25% of equity share capital of S Ltd. purchased at Rs. 10 per share.

It was agreed that A Ltd. should take over the entire undertaking of S Ltd. on 30.9.2007 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 30.9.2007 by S Ltd. was Rs. 70,500 after charging depreciation of Rs. 32,500 on block of assets. S Ltd. declared 10% dividend for 2006-2007 on 30.8.2007 and the same was paid within a week. Ignore corporate dividend tax.

Goodwill of S Ltd. was valued at Rs. 80,000 and block assets were valued at 10% over their book value as on 31.3.2007 for purpose of take over. Preference shareholders of S Ltd. will be allotted 10% preference shares of Rs. 10 each by A Ltd. Equity shareholders of S Ltd. will receive requisite number of equity shares of Rs. 10 each from A Ltd. valued at Rs. 10 per share.

(a) Compute the purchase consideration for the taken over business.

(b) Explain how the capital reserve or goodwill, if any, will appear in the balance sheet of A Ltd., after the amalgamation in the nature of purchase.

4. Super Express Ltd. and Fast Express Ltd. were in competing business. They decided to form a new company named Super Fast Express Ltd. The balance sheets of both the companies were as under :

Super Express Ltd.

Balance Sheet as at 31st December, 2007

	Rs.		*Rs.*
20,000 Equity shares of		Buildings	10,00,000
Rs. 100 each	20,00,000	Machinery	4,00,000

Provident fund	1,00,000	Stock	3,00,000
Sundry creditors	60,000	Sundry debtors	2,40,000
Insurance reserve	1,00,000	Cash at bank	2,20,000
		Cash in hand	1,00,000
	22,60,000		22,60,000

Fast Express Ltd.

Balance Sheet as at 31st December, 2007

	Rs.		Rs.
10,000 Equity shares of		Goodwill	1,00,000
Rs. 100 each	10,00,000	Buildings	6,00,000
Employees profit sharing		Machinery	5,00,000
account	60,000	Stock	40,000
Sundry creditors	40,000	Sundry debtors	40,000
Reserve account	1,00,000	Cash at bank	10,000
Surplus	1,00,000	Cash in hand	10,000
	13,00,000		13,00,000

The assets and liabilities of both the companies were taken over by the new company at their book values. The companies were allotted equity shares of Rs. 100 each in lieu of purchase consideration.

Prepare opening balance sheet of Super Fast Express Ltd.

5. The following were the Balance Sheets of P Ltd. and V Ltd. as at 31st March, 2008 :

Liabilities	*P Ltd.*	*V Ltd.*
	(Rs. in lakhs)	*(Rs. in lakhs)*
Equity Share Capital (Fully paid shares of Rs. 10 each)	15,000	6,000
Securities Premium	3,000	–
Foreign Project Reserve	–	310
General Reserve	9,500	3,200
Profit and Loss Account	2,870	825

12% Debentures	–	1,000
Bills Payable	120	
Sundry Creditors	1,080	463
Sundry Provisions	1,830	702
	33,400	12,500
Assets	*P Ltd.*	*V Ltd.*
	(Rs. in lakhs)	*(Rs. in lakhs)*
Land and Buildings	6,000	–
Plant and Machinery	14,000	5,000
Furniture, Fixtures and Fittings	2,304	1,700
Stock	7,862	4,041
Debtors	2,120	1,020
Cash at Bank	1,114	609
Bills Receivable	—	80
Cost of Issue of Debentures	—	50
	33,400	12,500

All the bills receivable held by V Ltd. were P Ltd.'s acceptances.

On 1st April 2008, P Ltd. took over V Ltd in an amalgamation in the nature of merger. It was agreed that in discharge of consideration for the business P Ltd. would allot three fully paid equity shares of Rs. 10 each at par for every two shares held in V Ltd. It was also agreed that 12% debentures in V Ltd. would be converted into 13% debentures in P Ltd. of the same amount and denomination.

Expenses of amalgamation amounting to Rs. 1 lakh were borne by P Ltd.

You are required to :

(i) Pass journal entries in the books of P Ltd. and

(ii) Balance sheet of P Ltd. After amalgamation.

6. The following are the summarised Balance Sheets of X Ltd. and Y Ltd :

	X Ltd.	*Y Ltd.*
	Rs.	*Rs.*
Liabilities :		
Share Capital	1,00,000	50,000
Profit & Loss A/c	10,000	–
Creditors	25,000	5,000
Loan X Ltd.	—	15,000
	1,35,000	70,000
Assets :		
Sundry Assets	1,20,000	60,000
Loan Y Ltd.	15,000	–
Profit & Loss A/c	—	10,000
	1,35,000	70,000

A new company XY Ltd. is formed to acquire the sundry assets and creditors of X Ltd. and Y Ltd. and for this purpose, the sundry assets of X Ltd. are revalued at Rs. 1,00,000. The debt due to X Ltd. is also to be discharged in shares of XY Ltd.

Show the Ledger Accounts to close the books of X Ltd.

UNIT – 5 : LIQUIDATION OF COMPANIES

Learning Objectives

After studying this unit, you will be able to

- ♦ Prepare Statement of affairs as per the format prescribed by the Act.
- ♦ Draw Deficiency account and will be able to point out the reasons for deficiency.
- ♦ Distinguish between Preferential payments and over-riding preferential payments.
- ♦ Set an order of payment of all obligations.
- ♦ Prepare Liquidator's Final Statement of account.

5.1. STATEMENT OF AFFAIRS

In the case of a winding up by Court, a Statement of Affairs of the company in the prescribed form verified by an affidavit, and containing particulars stated under section 454(1) has to be submitted to the Official Liquidator. The statement should be submitted by directors and one or more persons who are the manager, secretary or other chief of the company.

In the case of a voluntary winding up either by member or creditors, a Statement of Affairs is required to be submitted. According to the provisions contained under sections 496 and 508, Liquidator in both the types of winding up are required to hold a general meeting at the end of the first year and at the end of each succeeding year. They must lay before the meeting an account of their acts and dealing together with a statement in the prescribed form and containing prescribed particulars with respect to proceedings in and the position of the liquidation.

The Companies (Court) Rules, 1959 prescribe that the Statement of Affairs should be prepared in Form 57 contained in the Rules. The liquidators also are required to submit annual reports under sections 496 and 508. Such reports are to be presented in From 153 of the Rules. At the close of the winding up of proceedings in a voluntary liquidation, the liquidators are required to place before the final meeting of shareholders and creditors a consolidated account of the amounts received and paid out by him in Form 156 of the Rules.

The broad lines on which the Statement of Affairs is prepared are the following —

(1) Include assets on which there is no specific or fixed charge at the value they are expected to realise. Students should note to include calls in arrear but not uncalled capital.

(2) Include assets on which there is a fixed charge. The amount expected to be realised would be compared with the amount due to the creditor concerned. Any surplus is to be

extended to the other column. A deficit (the amount owed to the creditor exceeding the amount realisable from the asset) is to be added to unsecured creditors.

(3) The total of assets in paragraph (1) and any surplus from assets mentioned in paragraph (2) is available for all the creditors (except secured creditors already covered by specifically mortgaged assets).

(4) From the total assets available, the following should be deducted one by one and balance struck at each stage) :-

(*i*) Preferential creditors,

(*ii*) Debentures having a floating charge, and

(*iii*) Unsecured creditors.

If a minus balance emerges, there would be deficiency as regards creditors, otherwise there would be a surplus.

(5) The amount of total paid-up capital (giving details of each class of shares) should be added and the figure emerging will be deficiency (or surplus) as regards members.

5.2 DEFICIENCY ACCOUNT

The official liquidator will specify a date for period (minimum three years) beginning with the date by which information is to be supplied for preparation of an account to explain the deficiency or surplus. On that date either assets would exceed capital and liabilities, that is, there would be a reserve or there would be a deficit or debit balance in the Profit and Loss Account. The Deficiency account is divided into two parts. The first part starts with the deficit (on the given date) and contains every item that increases deficiency (or reduces surplus such as losses, dividends etc.). The second part starts with the surplus on the given date and includes all profits. If the total of the first exceeds that of the second, there would be a deficiency to the extent of the difference, and if the total of the second part exceeds that of the first, there would be a surplus. The deficiency or surplus must be the same as shown by the Statement of Affairs as regards members.

5.3 OVERRIDING PREFERENTIAL PAYMENTS

The Companies (Amendment) Act, 1985 has introduced section 529A which states that certain dues are to be settled in the case of winding up of a company even before the payments to preferential creditors under section 530. Section 529A states that in the event of winding up a company workmen's dues and debts due to secured creditors, to the extent such debts rank under section 529(1)(c), shall be paid in priority to all other debts. The workmen's dues and debts to secured creditors shall be paid in full, unless the assets are insufficient to meet them, in which case they shall abate in equal proportions.

It may be noted here that workmen's dues, in relation to a company, means the aggregate of the following sums:

(*i*) all wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any workman and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947;

(*ii*) all accrued holiday remuneration becoming payable to any workman or in the case of his death to any other person in his right, on the termination of his employment before, or by the effect of, the winding up order;

(*iii*) all amounts due in respect of any compensation or liability for compensation under Workmen's Compensation Act, 1923 in respect of death or disablement of any workman of the company;

(*iv*) all sums due to any workman from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the workmen maintained by the company.

5.4 PREFERENTIAL CREDITORS

Section 530 specifies the creditors that have to be paid in priority to unsecured creditors or creditor having a floating charge. Such creditors are known as Preferential Creditors. These are the following :

(*a*) All revenues, taxes, cesses and rates, becoming due and payable by the company within 12 months next before the commencement of the winding up.

(*b*) All wages or salaries (including wages payable for time or piece work and salary earned wholly or in part by way of commission) of any employee due for the period not exceeding 4 months within the twelve months next before commencement of winding up provided the amount payable to one claimant will not exceed Rs. 20,000.[*]

(*c*) All accrued holiday remuneration becoming payable to any employee on account of winding up.

Note: Person who advance money for the purpose of making preferential payments under (*b*) and (*c*) above will be treated as preferential creditors, provided the money is actually so used.

(*d*) Unless the company is being wound up voluntarily for the purpose of reconstruction, all contributions payable during the 12 months next under the Employees State Insurance Act, 1948, or any other law for the time being in force.

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[*]As per the Companies (Amendment) Act, 1996, the words "exceed such sum as may be notified by the Central Government in the official Gazette" shall be substituted for the words "exceed one thousand rupees" in section 530(2). [Vide Notification G.S.R. 80(E) dated 17-2-1997, the sum payable to any one claimant in relation to wages and salaries shall not exceed Rs. 20,000.]

(*e*) All sums due as compensation to employees under the Workmen's Compensation Act, 1923.

(*f*) All sums due to any employee from a provident fund, pension fund, gratuity fund or any other fund, for the welfare of the employees maintained by the company.

(*g*) The expenses of any investigation held under section 235 or 237 in so far as they are payable by the company.

Illustration 1

X Ltd. was ordered to be wound up on March 31st, 2008 on which date its balance sheet was as follows:

Liabilities		**Rs.**	**Assets**	**Rs.**
Subscribed Capital :				
10,000 shares of Rs. 100 each		10,00,000	Goodwill	1,00,000
5% Debentures	1,60,000		Building	3,50,000
Interest Accrued	4,000	1,64,000	Plant	5,50,000
(Secured by floating			Fixtures	23,000
charge on all assets)			Stock	38,000
Bank Overdraft		25,000	Debtors	25,000
(Secured by hypothecation of stock)			Cash	500
Sundry Creditors		36,000	P & L A/c	1,38,500
Total		12,25,000	Total	12,25,000

The amounts estimated to be realised are : Goodwill Rs. 1,000; Building Rs. 3,00,000; Plant Rs. 5,25,000; Fixtures Rs. 10,000; Stock Rs. 31,000; Debtors Rs. 20,000.

Creditors included Rs. 6,000 on account of wages of 15 men at Rs. 100 per month for 4 months immediately before the date of winding up : Rs. 9,000 being the salaries of 5 employees at Rs. 300 per month for the previous 6 months; Rent for godown for the last six months amounting to Rs. 3,000; Income-tax deducted out of salaries of employees Rs. 1,000 and Directors Fees Rs. 500.

Three years ago, the debit balance in the Profit and Loss Account was Rs. 77,925 and since that date the accounts of the company have shown the following figures:

	Year 31-3-2006	*Year 31-3-2007*	*Year 31-3-2008*
	Rs.	*Rs.*	*Rs.*
Gross Profit	65,000	45,000	40,000

Wages and Salaries	40,500	36,000	34,400
Electricity and Water Tax	5,750	6,380	5,260
Debentures interest	8,000	8,000	8,000
Bad Debts	8,540	7,600	6,700
Depreciation	6,700		
Directors' Fees	1,000	1,000	1,000
Miscellaneous Expenses	10,500	7,265	7,980
Total	80,990	66,245	63,340

In addition it is estimated that the company would have to pay Rs. 5,000 as compensation to an employee for injuries suffered by him which was contingent liability not accepted by the company.

Prepare the statement of Affairs and the Deficiency account in Form 57 of Companies (Court) Rules, 1959.

Solution:

Statement of Affairs (In liquidation) of X Ltd. on 31 March, 2008

	Estimated Realisable value
	Rs.
Assets not specifically pledged (as per list A)	
Cash	500
Debtors	20,000
Building	3,00,000
Plant	5,25,000
Fixtures	10,000
Goodwill	1,000
	8,56,500

Assets specifically pledged (as per list B)

	(a) Estimated Realisable Value Rs.	(b) Due to secured creditors Rs.	(c) Deficiency ranking as unsecured Rs.	(d) Surplus carried to the last column Rs.
Stock	31,000	25,000	—	6,000

		Rs.
Estimated surplus from assets specifically pledged		6,000
Estimated total assets available for preferential creditors, Debenture holders secured by a floating charge and unsecured creditors (carried forward)		8,62,500
Summary of Gross Assets :		
Gross realised value of assets specifically pledged	31,000	
Other Assets	8,56,500	
Total	8,87,500	

Liabilities

Gross Liabilities

Rs.		*Rs.*	*Rs.*
25,000	Secured creditors (as per list B) to the extent which claims are estimated to be covered by assets specifically pledged		
21,000	Preferential creditors (as per list 'C' Estimated		21,000
	balance of assets available for Debenture holders secured by a floating charge and unsecured creditors)		8,45,500
1,64,000	Debenture holders secured by floating charge (as per list D)		1,64,000
	Estimated surplus as regards debenture holders*		6,81,500
	Unsecured creditors (as per list E)		
	Estimated unsecured balance of claims of creditors partly secured on specific assets brought forward (*c*)	Nil	
	Creditors on Trade Account	20,500	
24,000	Outstanding Expenses	3,500	24,000
2,34,000	Estimated surplus as regards creditors, difference between Gross Assets (D) and Gross Liabilities as per column (E)		6,57,500

Issued and called up capital :	
1000 Equity Shares of Rs. 100 each fully called up	
as per list (G)	10,00,000
Estimated deficiency as regards contributories	3,42,500

***Note**: This must be read subject to the following :

(1) There is no unpaid capital to the called-up.

(2) The estimate are subject to cost of the winding up and to any surplus or deficiency on trading pending realisation of assets.

List H Deficiency Account

Items contributing to deficiency:

(1)	Excess of capital and liabilities over assets three years ago as shown by the balance sheet		77,925
(2)	Net dividends or bonuses declared during the period		Nil
(3)	Net Trading Losses (after charging items shown in Note below) for the same period		60,575
(4)	Losses other than trading losses written off or for which provision has been made in the books during the same period		Nil
(5)	Estimated losses now written off for which provision has been made for the purpose of preparing the statement:		
	Bad Debts	5,000	
	Loss on		
	Goodwill	99,000	
	Buildings	50,000	
	Plant	25,000	
	Fixtures	13,000	
	Stock	7,000	
	Workmen's Compensation	5,000	2,04,000
(6)	Other items contributing to deficiency:		3,42,500
	Items reducing deficiency:		Nil
	Deficiency as shown by the Statement of affairs		3,42,500

Notes as to net trading profits and losses :

Provision for depreciation on fixed assets	6,700
Charged of Income-tax	Nil
Interest on Debentures	24,000
Payment to directors made by the company and required by law to be disclosed in the accounts	3,000
Balance (being other trading losses)	26,875
	60,575

Particulars of Creditors for expenses	**Unsecured**	**Preferential**
Directors Fees	500	
Income tax on salaries	—	1,000
Rent (not distrained by landlord)	3,000	—
Wages (15 men for 4 months at Rs. 100 each)	—	6,000
Salaries (5 men for 6 months at Rs. 300 each, Rs. 9,000)		9,000
Workmen's Compensation		5,000
	3,500	21,000

Creditors on trade account are Rs. 28,500 (*i.e.,* Rs. 36,000 less the total of creditors mentioned above, excluding Rs. 9,000 for workmen's compensation).

Illustration 2

From the following particulars, prepare a Statement of Affairs and the Deficiency Account for submission to the official liquidator of the Equipment Ltd., which went into liquidation on December 31, 2007:

	Rs.	*Rs.*
3,000 equity shares of 100 each, Rs. 80 paid-up		2,40,000
6% 1,000 preference shares of Rs. 100 each fully paid-up	1,00,000	
Less : Calls in arrear	5,000	95,000
5% Debentures having a floating charge on the assets (interest paid upto June 30, 2005)		1,00,000
Mortgage on Land & Buildings		80,000
Trade Creditors		2,65,500
Owing for wages		20,000

Secretary's salary (@ Rs. 500 p.m.) owing		3,000
Managing Director's salary (@ Rs. 1,500 p.m.) owing		6,000

Assets	**Estimated to produce**	**Book value**
	Rs.	*Rs.*
Land & Building	1,30,000	1,20,000
Plant	1,30,000	2,00,000
Tools	4,000	20,000
Patents	30,000	50,000
Stock	74,000	87,000
Investments in the hands of a		
Bank for an overdraft of Rs. 1,90,000	1,70,000	1,80,000
Book Debts	60,000	90,000

On 31 December, 2002 the balance sheet of the company showed a general reserve of Rs. 40,000 accompanied by a debit balance of Rs. 25,000 in the Profit & Loss Account.

In 2003 the company made a profit of Rs. 40,000 and declared a dividend of 10% on equity shares. The company suffered a total loss of Rs. 1,09,000 besides loss of stock due to fire of Rs. 40,000 during 2004, 2005 and 2006. For 2007 accounts were not made.

The cost of winding up is expected to be Rs. 15,000.

Solution:

In the matter of the Companies Act, 1956

&

In the matter of Equipment Ltd. (in winding up)

Statement of Affairs on 31 December, 2007, the date of winding up.

	Estimated realisable value
Assets	Rs.
Assets not specifically pledged (as per list A)	
Trade debtors	60,000
Stock in trade	74,000
Plant	1,30,000
Tools	4,000
Patents	30,000
Unpaid calls	5,000
	3,03,000

Assets Specifically Pledged (as per list B)

	Estimated Realisation	Due to Secured Creditors	Deficiency Ranking as Unsecured Creditors	Surplus carried to the last column
	Rs.	Rs.	Rs.	Rs.
Investments	1,70,000	1,90,000	20,000	
Land & Building	1,30,000	80,000		50,000

	Rs.
Estimated surplus from assets specifically pledged	50,000
Estimated total assets available for preferential creditors, debenture holders and unsecured creditors	3,53,000
Summary of Gross Assets:	
Gross realisable value of assets specifically charged	3,00,000
Others assets	3,03,000
	6,03,000
Estimated total assets available for preferential creditors, debenture holders, bank overdraft and unsecured creditors brought forward	3,53,000

Gross Liabilities	*Liabilities*		
Rs.		*Rs.*	*Rs.*
2,50,000	Secured creditors (as per List B) to the extent to which claims are estimated to be covered by assets specifically pledge		
21,000	Preferential creditors as per list C		21,000*
	Estimated balance of assets available for Debenture holders, Bank & unsecured creditors		3,32,000
1,02,500	Debenture holders secured by a floating charge as per list D		1,02,500
	Surplus as regards debenture holders		2,29,500
	Unsecured creditors as per list E		

	Estimated unsecured balance of claim of creditors partly secured on specific assets	20,000	
	Trade creditors	2,65,500	
2,93,500	Outstanding expenses	8,000	2,93,500
	Estimated deficiency as regards creditors being the difference between gross liabilities and gross assets		64,000
6,67,000			

Issued & Called up Capital:

3,000 Equity shares or Rs. 100 each, Rs. 80 paid	2,40,000	
6% 1,000 preference shares of Rs. 100 each fully called	1,00,000	3,40,000
Estimated Deficiency as regards members as per list H.		4,04,000

***Note:-** For the purpose of section 530(1)(*b*) of the Companies Act, 1956, the term "employee" shall include officers and other administrative staff members but it shall not include workmen and managing director. In fact, section 530(8)(*bb*) clearly states that the expression 'employee' does not include a workman. Also section 2(26) read with the explanation to section 269 concludes that a managing director is not an ordinary employee and hence he should not be considered as an employee for the purpose of section 530. The Secretary of a Company, being an officer, is to be included within the definition of 'employee' for the purpose of section 530.

Note: (*i*) The above is subject to cost to winding up estimated at Rs. 15,000 and to any surplus in deficiency on trading realisation of assets.

(*ii*) There are 3,000 shares unpaid @ Rs. 20 per share liable to be called up.

List H - Deficiency Account

A.	*Item contributing to Deficiency:*	*Rs.*
1.	Excess of capital & liabilities over assets on 1-1-2005	Nil
2.	Net dividend & bonuses during the period Jan.-Dec. 2005	29,700
3.	Net trading losses after charging depreciation, taxation, interest on debentures, etc. during the same period (Rs. 1,09,000 + Rs. 1,31,300)	2,40,300
4.	Losses other than trading losses written off or for which provision has been made in the books during the same period - stock loss.	40,000

5.	Estimated losses now written off or for which provision has been made for the purpose of preparing the statement :		
		Rs.	
	Plant	70,000	
	Tools	16,000	
	Patents	20,000	
	Stock	13,000	
	Investments	10,000	
	Debtors	30,000	1,59,000
6.	Other reducing items contributing to deficiency		NIL
			4,69,000
B.	*Items reducing Deficiency*		
7.	Excess of assets over capital and liabilities on 1st Jan. 2003		15,000
8.	Net trading profit during the period 1st Jan. 2003 to 31st Dec. 2003		40,000
9.	Profit & Incomes other than trading profit during the same period		
10.	Other items Deficiency - Profit expected on Land & Building.		10,000
			65,000
Deficiency as shown by the statement of Affairs (A) - (B)			4,69,000
			4,04,000

Working Notes :

(1) Trial Balance to ascertain the amount of loss for 2007

	Dr.	*Cr*
	Rs.	*Rs.*
Land & Building	1,20,000	
Plant	2,00,000	
Tools	20,000	
Patents	50,000	
Stock	87,000	
Investments	1,80,000	
Debtors	90,000	
Equity Capital		2,40,000
6% Preference share capital		95,000

5% Debentures		1,00,000
Interest Outstanding		2,500
Mortgage on Land & Building		80,000
Trade Creditors		2,65,500
Owing for Wages		20,000
Secretary's Salary		3,000
Managing Director's Salary		6,000
Bank Overdraft		1,90,000
Profit & Loss Account on 1-1-2005	1,23,700	
	8,70,700	10,02,000
Loss for the year (balancing figure)	1,31,300	
	10,02,000	10,02,000

Reserve & Surplus Account

2002			Rs.	2002			Rs.
Dec. 31	To Profit & Loss A/c (Transfer)		25,000	Dec. 31	By	Balance b/d	40,000
2003 "	Dividend -	Equity	24,000	2003 Dec. 31	"	Profit for the year	40,000
		Preference	5,700	2004			
2004"	Profit & Loss A/c (Loss)		1,09,000	Dec. 31	"	Balance c/d	1,23,700
"	Loss of Stock		40,000				
			2,03,700				2,03,700

Illustration 3

X Co. Ltd. went into voluntary liquidation on 1st April, 2008. The following balances are extracted from its books on that date :

	Rs.		*Rs.*
Capital		Machinery	90,000
24,000 Equity Shares of Rs. 10 each	2,40,000	Leasehold properties	1,20,000
Debentures (Secured by		Stock	3,000
Floating charge)	1,50,000	Debtors	1,50,000
Bank overdraft	54,000	Investments	18,000
Creditors	60,000	Cash in hand	3,000
		Profit and loss account	1,20,000
	5,04,000		5,04,000

The following assets are valued as under :

	Rs.
Machinery	1,80,000
Leasehold properties	2,18,000
Investments	12,000
Stock	6,000
Debtors	1,40,000

The bank overdraft is secured by deposit of title deeds of leasehold properties. There were preferential creditors amounting Rs. 3,000 which were not included in creditors Rs. 60,000.

Prepare a statement of affairs to be submitted to the meeting of members/creditors.

Solution:

Statement of Affairs of X Co. Ltd. on the 1st day of April, 2008

Assets not specifically pledged :	Estimated realisable values
Cash in Hand	3,000
Investments	12,000
Debtors	1,40,000
Stock	6,000
Machinery	1,80,000
	3,41,000

Assets specifically pledged :

	(a) Estimated Realisable Value Rs.	(b) Due to Secured Creditors Rs.	(c) Deficiency ranking as unsecured Rs.	Surplus carried to last column Rs.	
Lease hold property	2,18,000	1,54,000	—	1,64,000	
	Estimated surplus from assets specifically pledged				1,64,000
	Estimated total assets available for preferential creditors, debentures holders secured by floating charge, and unsecured creditors				5,05,000

	Summary of Gross assets	(d)	
	Gross realisable value of assets specifically pledged	Rs. 2,18,000	
	Other assets	Rs. 3,41,000	
	Gross Assets	Rs. 5,59,000	
(*e*)			
Gross Liabilities Rs.	(to be deducted from surplus or added to deficiency as the case may be)		
	Secured creditors to the extent to which claims are estimated to be covered by assets		
54,000	Specifically pledged		
3,000	Preferential creditors		3,000
	Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors		5,02,000
1,50,000	Debentures		1,50,000
	Estimated surplus as regard debenture holders		3,52,000
60,000	Creditors		60,000
2,67,000			2,92,000
	Estimated surplus as regards creditors [being difference between gross assets (d) and gross liabilities (e)]		
	Issued and called up capital :		
	24,000 equity shares of Rs. 10 each		2,40,000
	Estimated surplus as regard members		52,000

Note: Statement of affairs should accompany eight lists :

List A Full particulars of every description of property not specifically pledged and included in any other list are to be set forth in this list.

List B Assets specifically pledged and creditors fully or partly secured.

List C Preferential creditors for rates, taxes, salaries, wages and otherwise.

List D List of debenture holders secured by a floating charge.

List E Unsecured creditors.

List F List of preference shareholders.

List G List of equity shareholders.

List H Deficiency or surplus account.

5.5 Liquidator's Final Statement of Account

In case of voluntary winding up, the statement prepared by the Liquidator showing receipts and payment of cash is called "Liquidator's Statement of Account" (Form No. 156). In case of compulsory winding up, the statement is known as Official Liquidator's Final Account (Form No. 156). While Preparing the Statement of Account, the following Points should be noted :

(*i*) Assets are included in the Prescribed order (or liquidity).

(*ii*) In case of assets specifically charged in favour of creditors, only the surplus from it, if any, is entered as "Surplus from Securities".

(*iii*) Net result of trading entered on the receipts side, profits being added and losses being deducted.

(*iv*) Payments made to redeem securities and cost of execution, *i.e.* cost of collecting debts, are deducted from the total receipts.

(*v*) Payments are made as shown in the following order :

   (*a*) Legal Charges;

   (*b*) Liquidator's Remuneration;

   (*c*) Liquidation Expenses;

   (*d*) Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);

   (*e*) Creditors;

   Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge). Unsecured creditors, shareholders for dividends declared but not yet paid;

   (*f*) Preference shareholders; and

   (*g*) Equity shareholders.

(*vi*) Arrears of dividends on cumulative preference shares should be paid up to the date of winding up.

(*vii*) In case of partly paid shares, it should be seen whether any amount is to be called up on such shares.

Firstly, the equity shareholders should be called up to pay the necessary amount (not exceeding the amount of uncalled capital) if creditors' claim/claims of preference shareholders cannot be satisfied with the amount. Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying off creditors.

(*viii*) The loss suffered by each class of shareholders, *i.e.* the amount that cannot be repaid, should be proportionate to the nominal value of the share. The loss per shares have nominal value of Rs. 100, and one set of shareholders has paid Rs. 80 per share and other set has paid Rs. 60 per share. Suitable adjustment will have to be made in cash in such a case; the latter set must contribute Rs. 20 first or the first set must be paid Rs. 20 first.

5.6 B List Contributories

The shareholders who transferred partly paid shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount (not exceeding the amount not called up when the shares were transferred) to pay off such creditors as existed on the date of transfer of shares and cannot be paid out of the funds otherwise available with the liquidator, provided also that the existing shareholders have failed to pay the amount due on the shares.

Illustration 4

In a liquidation which commenced on April 2, 2008 certain creditors could not receive payments out of the realisation of assets and out of the contributions from "A" list contributories. The following are the details of certain transfers, which took place in 2007 and 2008.

Shareholders	*Number of shares trans-*	*Date of ceasing to be member ferred at the date of*	*Creditors remaining unpaid and outstanding ceasing to be member*
X	1,500	1st March 07	4,000
A	1,000	1st May 07	6,000
B	1,500	1st July 07	7,500
C	300	1st Nov. 07	8,000
D	200	1st Feb. 08	9,500

All the shares were Rs. 10 each, Rs. 6 paid up ignoring expenses of and remuneration to liquidators, etc., show the amount to be realised from the various persons listed above.

Solution:

X will not be liable since he transferred his shares prior to one year preceding the date of winding up. The amount of Rs. 6,000 outstanding on 1st May 2007 will have to be contributed by A, B, C & D in the ratio of number of shares held by them, *i.e.* in the ratio of 10:15:3:2; thus A will have to contribute Rs. 2,000: B Rs. 3,000, C Rs. 600 and D Rs. 400. Similarly, the further debts incurred between 1st May, 2007 and 1st July 2007, viz. Rs. 1,500 for which A is not liable will be contributed by B, C and D in the ratio of 15:3:2 B will have to contribute Rs. 1,125. C will have to contribute Rs. 255 and D will contribute Rs. 150. The further increase from Rs. 7,500 to Rs. 8,000, viz. Rs. 500 occurring between 1st July and 1st Nov. will be shared by C and D who will be liable for Rs. 300 and Rs. 200 respectively. The increase between 1st Nov. and 1st Feb., is solely the responsibility of D.

The following statement makes the position clear:

Statement of Liabilities of B list contributors

Creditors Outstanding on the date of ceasing to be member	A 1,000 Shares Rs.	B 1,500 Shares Rs.	C 300 Shares Rs.	D 200 Shares Rs.	Amount to be paid to the Creditors Rs.
(1) 6,000	2,000	3,000	600	400	6,000
(2) 1,500	-	1,125	225	150	1,500
(3) 500	-	-	300	200	500
(4) 1,500	-	-	-	1,500	50*
Total (a)	2,000	4,125	1,125	2,250	8,050
(b) maximum liability on shares held	4,000	6,000	1,200	800	
(c) Amount paid (a) or (b) whichever is lower	2,000	4,125	1,125	800	

Illustration 5

M. Ltd. resolved on 31st December 2007 that the company be wound up voluntarily. The following was the trial balance extracted from its books as on that date:

	Rs.	*Rs.*
Equity shares of Rs. 10 each		2,00,000
9% Preference shares of Rs. 10 each		1,00,000
Plant (less depreciation w/o Rs. 85,000)	2,15,000	
Stock in trade	2,50,000	
Sundry Debtors	55,000	
Sundry Creditors	75,000	
Bank balance	74,000	

- Against D's liability of Rs. 2,250, he can be called upon to pay Rs. 800, the loss of Rs. 1,450 will have to be suffered by these creditors.

Preliminary Expenses	6,000	
Profit & Loss A/c (balance on 1st January, 2007)		30,000
Trading loss for the year 2007	24,000	
Preference dividend for the year 2007	6,000	
Outstanding Expenses (including mortgage interest)		25,000
4% Mortgage loan		2,00,000
Total	6,30,000	6,30,000

On 1st January, 2008 the liquidator sold to M. Ltd. Plant for Rs. 2,05,000 and stock in trade for Rs. 2,00,000. The sale was completed in January, 2008 and the consideration satisfied as to Rs. 2,62,200 in cash and as to the balance in 6% Debentures of the purchasing company issued to the liquidator at a premium of 2%.

The remaining steps in the liquidation were as follows:

(1) The liquidator realised Rs. 52,000 out of the book debts and the cost of collection amounted to Rs. 2,000.

(2) The loan mortgage was discharged on 31st January, 2008 along with interest from 31st July, 2007. Creditors were discharged subject to 2% and outstanding expenses excluding mortgage interest were settled for Rs. 2,000;

(3) On 30th June 2006 six month's interest on debentures was received from M. Ltd.

(4) Liquidation expenses amounting to Rs. 3,000 and liquidator's remuneration of 3% on disbursements to members were paid on 30th June, 2008 when :

   (*a*) The preference shareholders were paid out in cash; and

   (*b*) The debentures on M. Ltd. and the balance of cash were distributed ratably among the equity shareholders.

   Prepare the Liquidator's Statement of Account showing the distribution.

Solution:

M. Ltd. (in liquidation)

Liquidator's Statement of Account from 1st January, 2008 to 30th June, 2008

		Rs.			Rs.
Balance at Bank		74,000	Liquidator's remuneration		7302*
Realisation from :			(3% on Rs. 2,43, 398)		
Sundry Debtors		52,000	Liquidation Expenses		3,000
M. Ltd. -			Loan on mortgage with		
Rs. 1,40,000 6%			Accrued interest**		2,04,000
Debentures	1,42,800		Creditors including		
Cash	2,62,200		Outstanding Expenses		75,500
		4,05,000	Return contributors :		
6 months' interest			6% Preference shareholders		
on debentures		4,200	Rs. 10 per share		1,00,000
Equity shareholders		5,35,200	6% Debentures	1,42,800	
Less : Cost of Collection			Cash (03 P. approx.)		
of Debts		2,000	per share	598	1,43,398
Total		5,33,200	Total		5,33,200

Illustration 6

Insol Ltd. is to be liquidated. Their summarised Balance Sheet as at 30th September, 2007 appears as under:

Liabilities:	*Rs.*
2,50,000 equity shares of Rs. 10 each	25,00,000
Secured debentures (on land and buildings)	10,00,000
Unsecured loans	20,00,000
Trade creditors	35,00,000
	90,00,000

* 3/103 × 2,50,700 (i.e. Rs.5,32,000 less payments made to all creditors)

** It is assumed that loan is secured by a floating charge.

Assets:

Land and Building	5,00,000
Other fixed assets	20,00,000
Current assets	45,00,000
Profit and Loss A/c	20,00,000
	90,00,000

Contingent liabilities are :

For bills discounted	1,00,000
For excise duty demands	1,50,000

On investigation, it is found that the contingent liabilities are certain to devolve and that the assets are likely to be realised as follows:—

	Rs.
Land & Buildings	11,00,000
Other fixed assets	18,00,000
Current assets	35,00,000

Taking the above into account, prepare the statement of affairs.

Solution:

Statement of Affairs of Insol Ltd. (in Liquidation)

as on 30th September, 2007

	Estimated Realisable Value (Rs.)
Assets not specifically pledged:	
(As per list A)	
Other fixed assets	18,00,000
Current assets	35,00,000
	53,00,000
Assets specifically pledged	
(As per List B)	

	Estimated realisable value	Due to secured creditors	Deficiency		Surplus
	Rs.	Rs.	Rs.	Rs.	Rs.

Land & Buildings	11,00,000	10,00,000	1,00,000	1,00,000
Estimated total assets available to unsecured creditors				54,00,000

Summary of Gross Assets	*Rs.*
Gross realisable value of assets specifically pledged	11,00,000
Other assets	53,00,000
Gross Assets	Rs.64,00,000

Gross liabilities *Rs.*	**Liabilities**	
10,00,000	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets Specifically pledged	
1,50,000	Preferential creditors (as per list C)	1,50,000
		52,50,000
	Unsecured creditors (as per list E)	
20,00,000	Unsecured Loans	20,00,000
35,00,000	Trade creditors	35,00,000
1,00,000	Contingent Liability on Bills Discounted	1,00,000
67,50,000	Estimated deficiency as regards creditors (67,50,000—64,00,000)	3,50,000
	2,50,000 Equity Shares of Rs. 10 each : (as per list G)	25,00,000
	Estimated deficiency as regards members	28,50,000

Illustration 7

Prakash Processors Ltd. went into voluntary liquidation on 31st December, 2007 when their Balance Sheet read as follows:—

Liabilities	***Rs.***
Issued and subscribed capital :	
5,000 10% cumulative preference shares	
of Rs. 100 each, fully paid	5,00,000
2,500 equity shares of Rs. 100 each, Rs. 75 paid	1,87,500
7,500 equity shares of Rs. 100 each, Rs. 60 paid	4,50,000
15% Debentures secured by a floating charge	2,50,000
Interest outstanding on Debentures	37,500
Creditors	3,18,750
	17,43,750
Assets	
Land and Building	2,50,000
Machinery and Plant	6,25,000
Patents	1,00,000
Stock	1,37,500
Sundry Debtors	2,75,000
Cash at Bank	75,000
Profit and Loss A/c	2,81,250
	17,43,750

Preference dividends were in arrears for 2 years and the creditors included Preferential creditors of Rs. 38,000.

The assets realised as follows :—

Land and Building Rs. 3,00,000; Machinery and Plant Rs. 5,00,000; Patents Rs. 75,000; Stock Rs. 1,50,000; Sundry debtors Rs. 2,00,000.

The expenses of liquidation amounted to Rs. 27,250. The Liquidator is entitled to a commission of 3% on assets realised except cash. Assuming the final payments including those on debentures is made on 30th June, 2008 show the liquidator's Final Statement of Account.

Solution:

Prakash Processors Limited

Liquidator's Final Statement of Account

	Receipts		*Rs.*		*Payments*		*Rs.*
To	Assets realised -			By	Liquidation expenses		27,250
	Bank		75,000	"	Liquidator's Remuneration		36,750
	Other assets:			"	Debenture holders :		
	Land etc.	3,00,000			Debentures	2,50,000	
	Machinery etc.	5,00,000			Interest accrued	37,500	
	Patents	75,000			Interest 1-1-08/30-6-08	18,750	3,06,250
	Stock	1,50,000					
	Sundry Debtors	2,00,000	12,25,000	"	Preferential creditors		38,000
			13,00,000	"	Unsecured creditors		2,80,750
				"	Preferential shareholders :		
To	Call on equity shareholders				Preference capital	5,00,000	
	(7,500 × Rs. 2.65) (1)		19,875		Arrear of Dividend	1,00,000	6,00,000
							12,89,000
				"	Equity shareholders -		
					Rs. 12.35 on 2,500 shares		30,875
			13,19,875				13,19,875

Working Notes:

(1) Liquidator's remuneration 12,25,000 × 3/100 =Rs. 36,750

(2) As the company is solvent, interest on the debentures will have to be paid for the period 1-1-2008 to 30-6-2008

$$2,50,000 \times \frac{15}{100} \times \frac{1}{2} = \text{Rs. } 18,750$$

(3)

Total equity capital - paid up	Rs. 6,37,500
Less : Balance available after payment to unsecured and preference shares	
(13,00,000 — 12,89,000)	Rs. 11,000
Loss to be born by 10,000 equity shares	6,26,500
Loss per share	Rs. 62.65
Hence, amount of call on Rs. 60 paid share	Rs. 2.65
Refund to share on Rs. 75 paid	Rs. 12.35

Illustration 8

The following is the Balance Sheet of Confidence Builders Ltd., as at 30th Sept. 2008.

Liabilities		*Rs.*	*Asset*	*Rs.*
Share Capital			Land and Buildings	1,20,000
Issued : 11% Pref. Shares			Sundry Current Assets	3,95,000
of Rs. 10 each		1,00,000	Profit and Loss Account	38,500
10,000 equity shares of			Debenture Issue expenses	
Rs. 10 each, fully paid up		1,00,000	not written off	2,000
5,000 equity shares of				
Rs. 10 each, Rs. 7.50 per				
share paid up		37,500		
13% Debentures		1,50,000		
Mortgage Loan		80,000		
Bank Overdraft		30,000		
Creditors for Trade		32,000		
Income-tax arrears :				
(assessment concluded				
in July 2008)				
Assessment year 2006-2007	21,000			
Assessment year 2007-2008	5,000	26,000		
		5,55,500		5,55,500

Mortgage loan was secured against land and buildings. Debentures were secured by a floating charge on all the other assets. The company was unable to meet the payments and therefore the debenture holders appointed a Receiver for the Debenture holders brought the land and buildings to auction and realised Rs. 1,50,000. He also took charge of Sundry assets of value of Rs. 2,40,000 and realised Rs. 2,00,000. The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the due from their personal resources. Costs incurred by the Receiver were Rs. 2,000 and by the Liquidator Rs. 2,800. The Receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realised by him. Preference shareholders had not been paid dividend for period after 30th September 2006 and interest for the last half year was due to the debenture holders. Rest of the assets were realised at Rs. 1,00,000.

Prepare the accounts to be submitted by the Receiver and Liquidator.

Solution:

Receiver's Receipts and Payments Account

		Rs.			Rs.
Sundry Assets realised		2,00,000	Costs of the Receiver		2,000
Surplus received from			Preferential payments		
mortgage			Creditors paid - Taxes		
Sale Proceeds of land			raised within 12 months		26,000
and building	1,50,000		Debentures holders		
Less: Applied to discharge			Principal	1,50,000	
of mortgage loan	80,000	70,000	Interest for		
			half year	9,750	1,59,750
			Surplus transferred		
			to the Liquidator		82,250
		2,70,000			2,70,000

Liquidator's Final Statement of Account

	Rs.			Rs.
Surplus received from		Cost of Liquidation		2,800
Receiver	82,250	Remuneration to Liquidator		3,000
Assets Realised	1,00,000	Unsecured Creditors :		
Calls on Contributories :		Trade	32,000	
On holder of 5,000		Directors for		
at the rate of Rs.		Bank O/D		
2.17 per share	10,850	cleared	30,000	62,000
		Preferential Shareholders :		
		Principal	1,00,000	
		Arrears of		

Dividends	22,000	1,22,000	
	Equity shareholder : Return of money to contributors to holders of 10,000 shares at 33 paise each		3,300
1,93,100			1,93,100

Working note :

Call from party paid shares

Deficit before call from Equity Shares (1,82,250 — 1,89,800)	=	7,550
National call on 5,000 shares @ Rs. 2.50 each		12,500
Net balance after national call		(a) 4,950
No. of shares deemed fully paid		(b) 15,000
Refund on fully paid shares $\frac{4,950}{15,000}$	=	33p
Calls on party paid share (2.50 — 0.33)	=	Rs. 2.17

Self-Examination Questions

I. Objective Type Questions

Choose the appropriate answer from the given options

1. A company can be liquidated in any of three ways
   (a) Compulsory winding-up by the Court
   (b) voluntary winding-up by the members or creditors
   (c) winding-up under the supervision of the court
   (d) All of the above.
2. List H shows…………………… Account.
   (a) Deficiency or Surplus

(b) Preferential creditors

(c) Fixed assets account

(d) None of the above

3. When a company is wound-up, all persons who ceased to be the shareholders within a year before the winding-up are placed in the ……..

(a) 'A 'list of contributories

(b) 'B' list of contributories

(c) 'C' list of contributories

(d) 'D' list of contributories

[**Answer:** 1-(d), 2-(a), 3-(b)]

II. Short Answer Type Questions

4. What is B List of Contributories and also state the liability of contributories included in the list.

5. What do you mean by liquidation of a company? Describe the different modes of winding-up.

6. Explain the preferential creditors as given under the Indian Companies Act.

7. Explain the circumstances under which a liquidator would have to make a call on partly paid shares.

III. Long Answer Type Questions

8 What are the contents of "Liquidators' statement of account"? How frequently does a liquidator has to submit such statement?

9 Overriding preferential payments under section 529A of the Companies Act, 1956.

IV. Practical Questions

10. (a) Before paying the creditors totalling Rs. 3,04,000 the liquidators of a company were left with Rs. 1,25,000. The shares of the company were as follows:

(*i*) 3,000 9% preference shares of Rs. 100 each, Rs. 80 paid, (*ii*) 2,000 Equity shares of Rs. 100 each, Rs. 60 paid, and

(*iii*) 3,000 equity shares of 100 each, Rs. 75 paid.

What will be the call on the preference shares ?

(*b*) In a company where the shares are as mentioned above, the liquidator is left with Rs. 2,20,000 after paying off creditors. What will be the call on shares ?

11. A winding up order has been issued against M Ltd. The following information is obtained with regards to the assets and liabilities as on 30th June, 2008.

	Rs.
Freehold premises (book value Rs. 4,50,000) valued at	3,75,000
First Mortgage of Freehold premises	3,00,000
Second Mortgage of Freehold premises	1,12,500
8% Debentures carrying a floating charges on the undertaking,	
interest due 1st September and 1st April, and paid on due dates	1,50,000
Managing Directors' emoluments (6 months)	22,500
Staff salary unpaid (one month)	16,050
Trade Debtors (Good)	31,500
Doubtful (Estimated to realise 50%)	12,900
Bad	72,750
Plant and Machinery (Book value Rs. 2,47,500) Estimated to realise	1,74,000
Bank overdraft Unsecured	58,125
Cash in hand	825
Stock (at cost Rs. 50,850) Estimated to realise	33,900
Issued Capital:	
Equity shares of Rs. 10 each, fully called up	1,50,000
Calls on arrears, Rs. 3,000 Estimated to realise	1,500
Unsecured Creditors	2,96,250
Contingent Liability in respect of a claim for damages Rs. 37,500	
estimated to be settled for	18,000

Income-tax Liability:	
For 30-6-2006	5,250
For 30-6-2007	1,275
For 30-6-2008	2,700

The Reserve of the Company on 1-7-2007 amounted to Rs. 7,500

You are required to prepare:

(*i*) Statement of Affairs, and

(ii) Deficiency Account.

12. In a winding up of a company, certain creditors remained unpaid. The following persons had transferred their holding sometime before winding up:

Name	*Date of Transfer*	*No. of Shares transferred*	*Amount due to creditors on the date of transfer*
	2007		*Rs.*
P	January 1	1,000	7,500
Q	February 15	400	12,500
S	March 15	700	18,000
T	March 31	900	21,000
U	April 5	1,000	30,000

The shares were of Rs. 100 each, Rs. 80 being called up and paid up on the date of transfers.

A member, R, who held 200 shares died on 28th February, 2007 when the amount due to creditors was Rs. 15,000. His shares were transmitted to his son X.

Z was the transferee of shares held by T. Z paid Rs. 20 per share as calls in advance immediately on becoming a member.

The liquidation of the company commenced on 1st February, 2008 when the liquidator made a call on the present and the past contributories to pay the amount.

You are asked to quantify the maximum liability of the transferors of shares mentioned in the above table, when the transferees:

(i) pay the amount due as “present” member contributories;

(ii) do not pay the amount due as "present" member contributories.

Also quantity the liability of X to whom shares were transmitted on the demise of his father R.

13. The following was the Balance Sheet of X Limited as on 31.3.2008 :

Balance Sheet of X Limited as at 313.2008

Liabilities	***Rs.***	***Assets***	***Rs.***
Share Capital		Fixed Assets	
14%, 40,000 preference shares of		Land	40,000
Rs. 100 each fully paid up	4,00,000	Buildings	1,60,000
8,000 equity shares of Rs. 100 each,		Plant and Machinery	5,40,000
Rs. 60 per share paid up	4,80,000	Patents	40,000
Reserves and Surplus	NIL	Investments	NIL
Secured Loans		Current assets, loans and advances	
14% debentures	2,30,000	A. Current Assets	
(Having a floating charge		Stock at cost	1,00,000
on all assets)		Sundry debtors	2,30,000
Interest accrued on above		Cash at bank	60,000
debentures	32,200	B. Loans and Advances	NIL
(Also having a floating		Miscellaneous expenses	
charge as above)		Profit and Loss A/c	2,40,000
Loan on mortgage of land			
and building	1,50,000		
Unsecured Loan	NIL		
Current Liabilities and provisions			
Current liabilities			
Sundry creditors	1,17,800		
	14,10,000		14,10,000

On 31.3.2008 the company went into voluntary liquidation. The dividend on 14% preference shares was in arrears for one year. Sundry creditors include preferential creditors amounting to Rs. 30,000.

The assets realised the following sums

Land Rs. 80,000; Buildings Rs. 2,00,000; Plant and machinery Rs. 5,00,000; Patent Rs. 50,000; Stock Rs. 1,60,000; Sundry debtors Rs. 2,00,000.

The expenses of liquidation amounted to Rs. 29,434. The liquidator is entitled to a commission of 2% on all assets realised (except cash at bank) and 2% on amounts among unsecured creditors other than preferential creditors. All payments the on 30th June, 2008. Interest on mortgage loan shall be ignored at the time of payment.

Prepare the liquidator's final statement of account.

CHAPTER 5

FINANCIAL STATEMENTS OF INSURANCE COMPANIES

UNIT-1 INTRODUCTION TO INSURANCE BUSINESS

Learning Objectives

After studying this unit, you will be able to:

- Learn two main types of insurance business i.e. life insurance and general insurance and also the meaning of these types of insurance.
- Distinguish life insurance from general insurance.
- Learn the meaning of some important terms used in insurance business, namely premium, considerations for annuities granted, claims, surrender, bonus, paid-up policy, re-insurance and agents' balances.
- Understand the meaning of various types of fire, marine and miscellaneous policies.
- Provisions 11 of the Insurance Act, 1938 requiring preparation of financial statements for the insurance business and Section 14 of the Act requiring maintenance of register or record of policies.

1.1 INTRODUCTION

Under an insurance contract, one party, called insurer, undertakes to indemnify the losses suffered by the other party, called insured, for some specified causes in consideration for a fixed premium. The document that contains terms of insurance contract is called Insurance Policy. An insurance company makes profit if the claims of loss and expenses of insurance company are less than the premium collected by it; if the claims and expenses are more than the premium, it sustains losses. But insurance companies generally make profit, since the ratio of claims of policy holders to the total premium collected from them tends to be low.

In this unit, we shall discuss various types of insurance business and different types of insurance policies as an introduction before taking up the accounting issue. Also we shall discuss some relevant provisions of the Insurance Act, 1938, Insurance Regulatory and Development Authority Act, 1999, Insurance Regulatory and Development Authority Regulations, 2002.

1.2 VARIOUS TYPES OF INSURANCE

Insurance is basically of two types - life insurance and general insurance. *Life insurance* policy covers the life risk of the insured (or assured) upto the policy amounts. In case of death of the policy holder, the nominee of the assured could get the policy value. However, the life insurance policy also provides for payment of the policy value either at maturity or by instalments and an agreed bonus. *General insurance* means insurance other than life insurance. Section 2(6B) of the Insurance Act defines 'General Insurance Business' as fire, marine or miscellaneous insurance business whether carried on singly or in combination with one or more of them. Some common types of miscellaneous insurance in India are: exchange risk insurance, motor vehicle insurance, credit insurance, burglary insurance, workmen's compensation insurance, professional liability insurance, cash in transit insurance, fidelity insurance, etc. An important feature of the general insurance policy is that the insured gets compensation only in case of loss sustained by him due to reasons specified in the policy.

In India life insurance business can be conducted only by the Insurance Corporation of India, set up under an Act of Parliament; general insurance business is also taken over by the Government and four general insurance companies are now in operation with General Insurance Corporation of India as the holding company.

1.3 DISTINCTION BETWEEN LIFE INSURANCE AND OTHER FORMS OF INSURANCE

(1) Life insurance is a contract under which, in consideration of premiums paid by the insured, the insurer agrees to pay a fixed sum of money either on the death of insured or on the lapse of a specified number of years. Life policies may be issued in various forms, the most important of which are the following :-

(a) Whole Life Policy where the insured amount is payable only on death.

(b) Endowment policy where the insured amount is payable either on the lapse of specified number of years or on death, if it occurs earlier.

Note: Policies covered by (a) and (b) may be with profits or without profits.

(c) Annuity Contract where a specified amount is paid annually to the insured from the date he attains a specified age till his death.

(d) Multiple Benefit policy where, on maturity, the insured has several options, e.g., to obtain the full amount in cash or partly in cash and partly in the form of a "paid-up" policy or wholly in the form of a "paid-up" policy.

Fire, marine and miscellaneous insurance business represents the type of contract under which, in return for premiums paid by the insured, the insurer undertakes to reimburse the insured for any loss or liability he may incur on the happening of an uncertain event. There are several types of policies issued for each class of business.

(2) Since, in life insurance, the amount insured is payable on the happening of an event which is bound to occur, namely, the lapse of the period of time or the death of the insured, this form of insurance is frequently described as "assurance" business. Other forms of insurance provide only for the reimbursement of loss or liability incurred and, therefore, they are known as 'insurance' business. In practice, this distinction is not always observed, life insurance being termed both as "assurance" and "insurance" and other forms of insurance being known by the more comprehensive title of "general insurance".

(3) Human life, being invaluable, may be insured for any amount depending upon the premiums the insured is willing to pay. Other forms of insurance are contracts of indemnity and, therefore, notwithstanding the amount of policy, the sum payable under it is limited to the amount of loss actually suffered or the liability incurred.

(4) Life insurance contracts are long term contracts running over the number of years but general insurance contracts are only for one year though renewable year after year. In the latter case, when the year is over, there is no possibility of a claim but, in case of life insurance, lapse of a year means no such thing and, therefore, the premium received for that year cannot be treated as income.

1.4 TERMS USED IN INSURANCE BUSINESS

For a proper understanding of insurance business and the accounts, it is necessary for students to be acquainted with certain insurance terms.

(1) *Premium* - The payment made by the insured as consideration for the grant of the insurance is known as premium. The premium may be payable annually or at shorter intervals of time and may be payable throughout the period of the policy or only for a fixed term, depending upon the conditions in the policy.

(2) *Considerations for annuities granted* - As stated above, one form of life insurance is according to which annually a fixed sum is paid to the insured on his attaining a specified age. The amount paid to an insurance company as consideration for the payment of annuities is classified under this head in the Revenue Account. The amounts paid by the company are known as "Annuities".

(3) *Claims* - A claim occurs when a policy falls due for payment. In the case of life insurance business, it will arise either on death or on maturity of policy that is, on the expiry of the specified term of years. In the case of general insurance business, a claim arises only when the loss occurs or the liability arises.

(4) *Surrender* - Where the holder of a life insurance policy wishes to realise the amount of policy before the expiry of the full period of policy he surrenders his rights under the policy and in lieu thereof is paid an amount calculated according to a fixed formula adopted by the company which is made known to the insured at the time he takes out the policy. Before nationalization of insurance, a policy normally acquires a surrender value only after three annual premiums had been paid. The policies issued by the Life Insurance Corporation, however, acquire surrender value after two annual premiums have been paid.

(5) *Bonus* - A life insurance policy may be "with profit" or "without profits". The holder of a "without profits" policy is entitled to receive on maturity only the amount specified in the policy; but on a "with profits" policy he is entitled to receive in addition, the amount of bonuses declared on each valuation. On each valuation, the amount standing to the credit of Life Fund which is in excess over net liability, as determined by the actuary, is distributed among the shareholders and the policyholders. The share of the policyholders is paid to them as bonus, either in cash on declaration or by reduction of future premiums, or on maturity of the policy. Until the bonus is paid, it does not figure in the Revenue Account and is not payable in cash immediately but is to be payable at the time of the claim; it is described as Reversionary Bonus. The amount of Reversionary Bonus is included in claims.

Interim Bonus - It is a bonus paid to a policyholder for a period for which valuation is not complete and, therefore, the exact profit or bonus has not been determined. Such a bonus is also included in claims.

(6) *Paid-up Policy* - If an insured is unable to continue to paying premiums on his life policy, he may discontinue the payment and convert the policy into a "Paid-up" policy. The insured amount in that case will be reduced to a figure ascertained according to the following formula :

$$\text{Paid-up value} = \frac{\text{No. of premium paid} \times \text{Sum assured}}{\text{Total No. of prremiums payable}}$$

Other conditions of the policy, however, will remain unchanged.

(7) *Reinsurance* - If an insurer does not wish to bear the whole of risk of a policy, he may reinsure a part of risk with some other insurer. In such a case the insurer is said to have ceded a part of his business to other insurer. If, on the other hand, he insures the risk underwritten by another assurance company, he is said to have accepted reinsurance

business. In such a case, on a claim arising, the claim will be shared between the two companies in the proportion they had agreed to underwrite the risk.

(8) *Agents' Balances* - Under ideal conditions the agents' balances at the year-end should always be at credit since they relate to commission payable for the month of December which is paid in the subsequent month. The accounting practice for business accepted through agents varies from company to company. Generally, the agents' balances include both the premium accepted and the commission payable to them. Some companies account the premium accepted through agents under Agents' Premium Account and maintain separate Agents' Commission Account to facilitate correct premium accounting and to exercise effective control. The balances under Agents' Premium Account should normally be nil or only credit balances relating mainly, to refunds issued to the insured but not paid. However, in practice, large premium balances - both debit and credit - appear under the Agents' Premium Account mainly because of wrong posting of premium accounts from one agent to another or credits appearing for one class of business not being set-off against debits for another class of business or the sum insured. In some instances, the premium receipts get directly credited to Agents' Premium Account but policy is not timely issued.

At the divisional level, the agents' balances - both credit and debit - pertaining to premium and commission are separately exhibited and the relevant schedule compiled. In fact, the premium amounts are neither due from agents not due to agents since refunds, if any, cannot be paid to agents in terms of the provisions of the Insurance Act but only to the insured. Sometimes premiums receivable within a stipulated time are also debited in the Agents' Ledgers. Strictly speaking these cannot be said agents' balances and the net debit is therefore shown in the accounts of the company.

1.5 VARIOUS TYPES OF GENERAL INSURANCE

The general insurance business in India is governed by the Insurance Act, 1938 which is based on the British Insurance Act. The Act was amended in 1969 for 'social control' to govern the general insurance business on healthy lines. However, it was felt that there still existed some scope for improvement. In view of this, on May 13, 1971 the government nationalised the general insurance industry by an ordinance which became the General Insurance (Nationalisation) Act, 1972. At that time there were 63 domestic insurance companies and 44 foreign insurance companies operating in India. The managements of all the 107 companies were taken over by the Government and accordingly the General Insurance Corporation (GIC) was formed as a government company in November 1972. The GIC as the holding company is entrusted with the task of superintending, controlling and carrying on the general insurance business in the country. Its subsidiaries in all the four zones of the country viz., the Oriental

Fire & General Insurance Company (now known as the Oriental Insurance Co. Ltd.), the National Insurance Company Ltd., the New India Assurance Company Ltd. and the United India Insurances Company do all classes of direct business of general insurance except aviation which is done by the GIC.

1.5.1 Fire Insurance - A fire insurance contract may be defined as an agreement whereby one party, for a consideration, undertakes to indemnify the other party upto an agreed amount against financial loss of goods or property which the latter may suffer because of fire. Fire insurance thus covers the risk of loss of property by accidental and non-intentional fire.

Types of Fire Policies

(i) *Valued policy* - A policy in which the value of the property is ascertained and/or agreed upon which the insurer undertakes to pay in the event of destruction of goods/property by fire is known as *valued policy.* This type of policy is not very common these days.

(ii) *Specific policy* - It is a policy which insures a risk for a specific amount. In case of any loss under this policy, the insurer pays whole loss provided it is not more than the sum specified in the policy. Thus, the value of the goods/property is not considered for this purpose.

(iii) *Average policy* - An average policy contains the 'average clause' which lays down that if the property is under-insured, *i.e.* insured for a sum smaller than the value of the property, the insurer will bear only that proportion of the actual loss which the sum assured bears to the actual value of the property at the time of loss.

(iv) *Floating policy* - It is the policy which covers several types of goods lying at different locations under one amount and for one premium. The premium normally charged under this policy is the average of the premia that would have been paid if each lot of the goods had been insured under specific policies for specific sums.

(v) *Excess policy* - Where the stocks of the insured fluctuate he may take out a policy for the amount below which his stocks normally do not fall and another policy to cover the maximum amount of stocks which may be reached at times. The former type of policy is known as the *First Loss Policy* and the latter as the *Excess Policy.*

(vi) *Blanket policy* - A blanket policy is that which covers all assets - fixed as well as current - under one policy.

(vii) *Comprehensive policy* - A policy which covers risks such as fire, flood, riots, strikes, burglary etc. upto a certain specified amount is known as the comprehensive policy.

(viii) *Consequential loss policy* - The objective of this policy is to indemnify the insured against the loss or profit caused by any interruption of business due to fire. It is also known as *Loss of Profit Policy.*

(ix) *Re-instatement policy* - It is a policy under which the insurer pays the amount which is sufficient to re-instate assets or property destroyed.

(x) *Open declaration policy* - It is a policy whereby the insured makes a deposit with the insurer and declares the value of the subject matter in respect of which risk is covered.

Such policies are normally taken where the value of stocks etc. fluctuates considerably.

1.5.2 Marine Insurance - Marine insurance is perhaps the oldest type of insurance. Under a contract of marine insurance, the insurance company or the underwriter agrees to indemnify the owner of a ship or cargo against risks which are incidental to marine adventure such as sinking or burning of the ship and its contents, stranding of the ship, collision of ship, *Jettison, i.e.,* throwing overboard the cargo into the sea to save the ship from sinking or some other imminent danger, *barratry, i.e.,* wrongful act of the captain of the ship in destroying or stealing the vessel or cargo causing loss to owners.

Types of Marine Insurance - The common types of marine insurance are as follows :

(*i*) *Cargo insurance* - This type of marine insurance covers risks to the cargo on the ship. The cargo on the ship is exposed to risks arising from an act of God, enemies, fire etc.

(ii) *Hull insurance* - The ship is also exposed to the perils described in (*i*) above. Therefore, the owner of the ship may effect 'hull' insurance to cover such perils.

(*iii*) *Freight insurance* - Where the owner of goods promises or undertakes to pay the freight when the cargo is safely delivered at the port of destination and the cargo is destroyed on the way, the shipping company would lose the freight. The shipping company can cover this risk by taking out a freight insurance policy.

The persons who insure cargo, hull or freight are known as underwriters because they write their name and sign at the foot of the policy. Originally, only individuals used to underwrite the policies in their own names. Later associations were formed for this purpose, the pioneer being the Lloyd's Association which was formed in 1774. In the year 1779, the Association adopted a definite policy known as the "Lloyd's policy" which is in use even now.

Types of Marine Losses - Marine losses may be broadly of two types - (*i*) Total loss, and (*ii*) Partial loss which are discussed below :

(i) *Total Loss :* When the subject matter of insurance, *i.e.,* cargo, ship, freight etc. is totally lost, it is known as a 'total loss'. Total loss is also of two types :

(a) *Actual Total Loss* - When the subject-matter of insurance is absolutely destroyed or totally lost to the insured, it is known as actual total loss.

(b) *Constructive Total Loss* - When the subject matter is not actually totally lost but is lost for all practical purposes *e.g.,* where the ship or cargo is reasonably abandoned and taken as lost or expenses to be incurred for saving the cargo or the ship are expected to be more than the value thereof, it is known as constructive total loss.

(ii) *Partial Loss :* When only a part of the subject matter is lost, it is known as partial loss. This loss may also be of two types as discussed below :

(a) *General Average Loss* - Such a loss is caused by extraordinary voluntary sacrifice made or expenditure incurred with the objective of protecting the interests of all owners in a voyage. An example of this type of loss is when the ship has run aground and part of the cargo is to be jettisoned to lighten the ship to save it as well as the cargo from total loss.

(b) *Particular Average Loss* - It is a partial loss of the subject matter of insurance caused by a peril against which it is insured but which is not a general average loss.

Types of Marine Insurance Policies - Generally a standard form for all policies is used for all marine insurance policies to cover various types of risks. However, differing needs of the insured have led to the evolution of a variety of marine insurance policies, the main among which are :

(i) *Time policy* - It is that policy which covers the risk of the subject matter for a specified period of time. It is generally used for hull insurance though it can be taken out also for cargo.

(ii) *Voyage policy* - This is a policy whereby the subject matter in transit is insured from one place to another. It is generally carried out for cargo which is exposed to marine risks in transit.

(iii) *Mixed policy* - This is also known as *time and voyage policy* as under this the subject matter on a particular voyage is insured for a specified period of time.

(iv) *Floating policy* - This policy is taken out by cargo owners who make regular shipments of cargo to insure the shipments expected to be shipped for a certain time by one policy. At the time the cargo is shipped, the insured declares the value of the shipment and the total value of the policy is reduced by that amount.

(v) *Blanket policy* - This policy is taken for a specified amount, the premium in respect of which is paid for the entire policy at the beginning itself and is adjusted at the end of the specified period for the value of risks covered during this period.

(vi) *Fleet insurance policy* - This policy insures the whole fleet of ships.

(vii) *Open policy* - This type of policy is taken out without specifying the value where at the time of insurance, the insured is not aware of the value of the subject matter to be insured, which is ascertained and declared to the insurer later. The insurance cover is subject to the limit of the sum assured.

(viii) *Port policy* - This policy covers the ship when it is docked/stationed at a port.

(ix) *Composite policy* - It is a policy underwritten by more than one underwriter. The liability of each underwriter is however distinct and separate.

(x) *Valued policy* - Under this policy, the value of the subject matter is agreed between the underwriters and the insured at the time of taking the policy and is specified therein.

Clauses in a Marine Policy :

A marine policy may cover or exclude various types of risks. In view of this some special clauses may be inserted in the policy. Some of the important clauses are discussed below:

(i) *Lost or Not Lost Clause* - When this clause is inserted in the policy, the goods net insured irrespective of whether they are already lost or not lost before the policy is taken out. In other words, it covers loss of goods occurring between shipment of goods and the issuance of policy.

(ii) *Waiver Clause* - When this clause is included in a marine policy no act of the insurer or the insured in saving, maintaining and preserving the cargo or the hull will be considered as a "waiver", i.e., in case the insured takes steps under Sue, Labour and Travel clause after the notice of abandonment is given by him to the insurer but is not accepted by the insurer, it will not amount that the notice of abandonment is waived. Thus, if the insurer takes any such steps, it cannot be taken to mean as an acceptance of the notice of abandonment.

(iii) *Permission to Touch and Stay Clause* - As per this clause, the ship is permitted to touch and stay at the ports mentioned in the policy in the order specified therein. In case nothing is specified, the ship must touch and stay at ports which are normally touched in the particular trade. Any deviation from the route specified is permitted in an emergency to save the ship and the lives of the passengers.

(iv) *Running Down Clause (RDC)* - This clause enables the insured to claim the loss caused by collision with another ship.

(v) *Free of Capture and Seizure Clause (FCS)* - This clause is included in the policy to clarify that the underwriters will not be liable for any loss caused by ship being captured or seized in a war or warlike situation.

(vi) *Continuation Clause* - This clause may be included in a time policy whereby the ship will be covered until the end of the voyage or for not more than 30 days thereafter where the ship is still at sea at the time of expiry of the policy. A monthly *pro rata* premium is required to be deposited for this purpose.

(vii) *Excepted Perils Clause* - This clause specifies the risks not covered by the insurance policy.

(viii) *Free of Particular Average (FPA) and Free of All Averages (FAA) Clauses* - As the names suggest, the FPA clause exempts the underwriter from particular average and all averages, i.e., both general and particular average liabilities (discussed hereinafter).

(ix) *Insurance Clause* - This clause covers, among others, the losses caused by the negligence of master, crew etc. or by explosives or by other defects in machinery of the ship.

(x) *Jettison Clause* - This clause covers the loss caused by jettisoning of goods, i.e., throwing overboard goods to reduce the weight of the ship and prevent capture by the enemy.

(xi) *Barratry* - This clause covers all losses caused by wilful misconduct or defaults of the master and crew of the ship.

Miscellaneous Insurance Policies

In addition to the types of general insurance business discussed above, there are a number of insurance policies which cover various other types of risks, the important ones of which are discussed hereinafter.

Motor Vehicle Insurance - Motor Vehicle insurance policies are normally taken out to cover two types of risk—(*i*) the risk of damage by an accident or loss by theft, and (*ii*) risk of liability arising from an injury or death of any person in an accident caused by a vehicle, commonly known as Third Party Insurance. The owner of a vehicle is compulsorily required to get third party insurance under the Indian Motor Vehicles Act whereas the other types of insurance are voluntary.

Fidelity Insurance - This type of insurance protects an employer against the frauds, defalcations etc., on the part of his employees where, as part of their employment obligations, such employees are required to handle cash, goods or other valuables of the employer.

Credit Insurance - Credit insurance is taken out to protect the insured against the losses caused by bad debts due to insolvency of the debtors or otherwise.

Burglary Insurance - Burglary insurance policy is issued whereby the insurer undertakes to indemnify the insured against losses from burglary, i.e., the removal of movable goods by theft or burglary.

Loss of Profit Insurance - Loss of profits insurance is often accompanied by fire insurance and it covers the risk of loss of profits caused by fire, including fixed costs which are continued to be incurred till the business starts functioning at its normal level.

Workmen's Compensation Insurance - This type of insurance covers the risk of liability arising on account of payment of compensation where a worker suffers injury or dies in an accident in the course of his employment.

Professional Liability Insurance - A professional liability insurance protects the professionals, such as doctors, lawyers and accountants, against the risk of liabilities arising towards clients of third parties in connection with their work. This may also include legal expenses incurred in defending law suits.

The scope of miscellaneous insurance business is very wide and encompasses almost all commercial activity.

1.6 SOME RELEVANT PROVISIONS OF THE INSURANCE ACT, 1938

The Insurance Act, 1938 (hereinafter referred to as the Act) and the Insurance Rules, 1939 set out the provisions and rules which have a bearing on accounts and audit. After the nationalisation of General Insurance business, many of the provisions contained in the Act have become irrelevant. This sub-section deals with the relevant provisions of the law. (Refer para 1.7 simultaneously to know the amendments made by IRDA Act, 1999)

Section 11(1) of the Act requires that every insurer in respect of all insurance business shall prepare (*a*) a balance sheet in accordance with regulations contained in Part I of the First Schedule and in the form set forth in Part II of that Schedule (*b*) a profit and loss account in accordance with the regulations contained in Part I of the Second Schedule and in the forms set forth in Part II of that Schedule, and (*c*) a revenue account in accordance with the regulations and in the forms set forth in the Third Schedule in respect of each class or sub-class of insurance business.

Section 11(2) of the Act requires that the accounts and statements shall be signed by the chairman, if any, and two directors and the principal officer of the company and shall be accompanied by a statement containing the names, descriptions and occupations of and the directorships held by the persons in charge of the management of the business during the period of which such accounts pertain.

It has been the general practice in general insurance companies to indicate in their notes to the accounts that the Balance Sheet, the Profit and Loss Account, the Profit and Loss Appropriation Account and Revenue Accounts are drawn up in accordance with the provisions of Section 11(1) of the Insurance Act, 1938, read with provisions of Sub-sections (1), (2) and (5) of Section 211 and Sub-section (5) of Section 227 of the Companies Act, 1956.

The Act also provides that the accounts of the companies carrying on general insurance business be audited as per the requirements of the Companies Act, 1956.

Section 14 of the Act requires that every insurer shall maintain a register or record of policies showing in respect of every policy, the names and addresses of policy holders, the date when the policy was effected and record of any transfer, assignment or nomination of which the insurer has notice. Every insurer must also maintain a register or record of claims in which shall be entered, every claim made, date of the claim, the name and address of the claimant and the date on which the claim was discharged, or, in the case of a claim which is rejected, the date of rejection and the grounds therefor.

Apart from the above records required to be maintained under the Act, Rule 39 of the Insurance Rules, 1939 also provides for maintenance of certain other records.

Section 15 of the Act prescribes that the audited accounts and statements shall be printed and four copies thereof shall be furnished as returns to the Controller within six months from the end of the period to which they refer. Of the four copies so furnished one shall be signed by the chairman and two directors and by the principal officer of the company, and if the company has a managing director, by that director.

Section 17 of the Act provides that the balance sheet and the profit and loss account prepared in accordance with Section 11 of the Act, and filed with the Registrar of Companies, will be a sufficient compliance with the provisions of Section 220 of the Companies Act, 1956.

Section 27B of the Act requires that no insurer carrying on general insurance business shall invest any part of his assets otherwise than in the approved investments listed in this section.

According to Section 28B of the Act, every general insurance company shall submit a return of investments in the prescribed form to the Controller, indicating therein the changes in the investments, within the stipulated period. A statement containing various encumbrances on assets must also accompany the aforesaid return.

Section 40 of the Act prohibits payment of commission to any person other than an authorised agent for soliciting or procuring business, subject to a maximum of 15 per cent of the premium.

Section 40A(3) of the Act, deals with limits of expenditure by way of commission which normally ranges between 5 per cent and 15 per cent subject to review thereof by the General Insurance Corporation.

Section 40C of the Act lays down provisions regarding limits on expenses of management in general insurance business. Rule 17E of the Insurance Rules, 1939, prescribes the various limits in detail.

1.7 INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY ACT, 1999 (SOME RELEVANT AMENDMENTS IN INSURANCE ACT, 1938)

The Insurance Regulatory and Development Authority Act, 1999 is an act to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto and further to amend the **Insurance Act, 1938** the **Life Insurance Corporation Act, 1956** and the **General insurance Business (Nationalisation) Act, 1972** to end the monopoly of the Life Insurance Corporation of India (for the insurance business) and General Insurance Corporation and its subsidiaries (for general insurance business).

The Act was published in the Gazette of India on 29th Dec., 1999 and extends to the whole of India. Words and expressions used and not defined in this Act but defined in the **Insurance Act, 1938 or the Life Insurance Corporation Act, 1956 or the General Insurance Business (Nationalisation) Act, 1972** shall have the meanings respectively assigned to them in those Acts.

The Insurance Regulatory and Development Authority also notified Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000 in the Gazette of India on 14th August, 2000, which have been discussed in unit 4 of the chapter.

Some relevant amendments made by the Insurance Regulatory and Development Authority Act (IRDA Act, 1999) in the Insurance Act, 1938 have been discussed below :

IRDA Act, 1999 (in the Fist Schedule vide Section 30) has made the following relevant amendments to the Insurance Act, 1938

Section 11 –

(a) in sub-section (1) for ‘calendar year’, substitute ‘financial year’.

(b) after sub-section (1) insert the following :–

“(1A) Notwithstanding anything contained in sub-section (1), every insurer, on or after the commencement of the Insurance Regulatory and Development Authority Act, 1999, in respect of insurance business transacted by him and in respect of his shareholders’ funds, shall at the expiration of each financial year, prepare with reference to that year, a balance sheet, a profit and loss account, a separate account of receipts and payments, a revenue account in accordance with the regulations made by the authority.

(1B) Every insurer shall keep separate accounts relating to funds of shareholders and policy-holders."

Section 27 –

After Section 27B, IRDA Act, 1999 has inserted the following sections in the Insurance Act, 1938 –

"27C. Prohibition of investment of funds outside India. No insurer shall directly or indirectly invest outside India the funds of the policy-holder.

27 D. Manner and conditions of investment – (1) Without prejudice to anything contained in section 27, 27A and 27B, the authority may, in the interests of the policy-holders, specify by the regulations made by it, the time, manner and other conditions of investment of assets held by an insurer for the purposes of this Act.

(2) The Authority may give specific directions for the time, manner and other conditions subject to which the funds of the policy-holders shall be invested in the infrastructure and social sector as may be specified by regulations made by the Authority and such regulations shall apply uniformly to all the insurer carrying on the business of life insurance, general insurance, or re-insurance in India on or after the commencement of the Insurance Regulatory and Development Authority Act, 1999.

(3) The Authority may after taking into account the nature of business and to protect the interest of the policy-holders, issue to an insurer the directions relating to the time, manner and other conditions of investment of assets to be held by him :

Provided that no direction under this sub-section shall be issued unless the insurer concerned has been given a reasonable opportunity of being heard."

In Section 28A and 28B in sub-section (1), for "31st day of December," IRDA Act has substituted "31st day of March".

Section 40A, in sub-section (3), for the portion beginning with the word "an amount exceeding" and ending with the words "ten percent of the premium payable on the policy", IRDA Act has substituted "an amount not exceeding fifteen percent of the premium payable on the policy where that policy relates to fire or marine insurance or miscellaneous insurance.".

Section 64 V –

(a) in sub-section (1) -

(i) in clause (i) after sub-section clause (g), insert the following :-

"(h) such other asset or assets as may be specified by the regulations made in this behalf;";

(ii) in clause (ii) -

(A) in sub-clause (b) in items (i) and (ii), for "40 per cent", substitute "50 per cent.";

(B) after sub-clause (f), insert the following :-

"(g) such other liability which may be made in this behalf to be included for the purpose of clause (ii).";

(b) for sub-section (2), substitute the following :-

"(2) Every insurer shall furnish to the Authority with his returns under section 15 or section 16, as the case may be, a statement certified by an auditor approved by the Authority in respet of general insurance business, or an actuary approved by the Authority in respect of life insurance business, as the case may be, of his assets and liabilities assessed in the manner required by this section as on the 31st day of March of the preceding year.

(3) Every insurer shall value his assets and liabilities in the manner required by this section and in accordance with the regulations which may be made by the Authority in this behalf."

Section 64V A -

(a) in sub-section (1), for "at all times", substitute "at all times before the commencement of the Insurance Regulatory and Development Authority Act, 1999";

(b) after sub-section (1), insert the following :-

"(1A) Every insurer shall, at all times, on or after the commencement of the Insurance Regulatory and Development Authority Act, 1999, maintain an excess of the value of his assets over the amount of his liabilities of not less than the amount arrived at as follows (hereinafter referred to in this section as the "required solvency margin"), namely :-

(i) in the case of an insurer carrying on life insurance businss, the required solvency margin shall be the higher of the following amounts :-

(a) fifty crores of rupees (one hundred crores of rupees in cae of re-insurers); or

(b) the aggregate sums of the results arrived at in items (I) and (II) stated below :-

(I) the aggregate of the results arrived at by applying the calculation described in item (A) below (Step - I) and the calculation described in item (B) below (Step II) :

(A) for step I -

(A.1) there shall be taken, a sum equal to a percentage determined by the regulations not exeeding five per cent of the mathematical reserves for direct business and re-insurance acceptances without any deduction for re-insurance cessions.

(A.2) the amount of mathematical reserves at the end of the preceding financial year after the deduction re-insurance cessions shall be expressed as a percentage of the amount of those mathematical reserves before any such deduction; and

(A.3) the sum mentioned in item (A.1) above shall be multiplied-

(A.3.1) where the percentage arrived at under item (A.2), above is greater than eighty-five per cent (or in the case of a re-insurer carrying of exclusive re-insurance business, fifty per cent), by that greater percentage; and

(A.3.2) in any other case, by eighty-five per cent (or in the case of re-insurer carrying on exclusive re-insurance business, by fifty per cent);

(B) for step II-

(B.1) there shall be taken, a sum equal to a percentage determined by the regulations made by the Authority not exceeding one per cent of the sum at risk for the policies on which the sum at risk is not a negative figure, and

(B.2) the amount of sum at risk at the end of the preceding financial year for policies on which the sum at risk is not a negative figure after the deduction of re-insurance cession shall be expressed as a percentage of the amount of that sum at risk before any such deduction, and

(B.3) the sum arrived at under item (B.1) above shall be multiplied -

(B.3.1) where the percentage arrived at under item (B.3.2) above is greater than fifty per cent, by that greater percentage; and

(B.3.2) in any other case, by fifty per cent,

(II) a percentage determined by the regulations made by the Authority of the value of assets determined in accordance with the provisions of section 64V;

(ii) in the case of an insurer carrying on general insurance business, the required solvency margin, shall be the highest of the following amounts :-

(a) fifty crores of rupees (one hundred crores of rupees in case of re-insurer); or

(b) a sum equivalent to twenty per cent of net premium income; or

(c) a sum equivalent to thirty per cent of net incurred claims,

subject to credit for re-insurances in computing net premiums and net incurred claims being actual but a percentage, determined by the regulations not exceeding fifty per cent :

Provided that if in respect of any insurer, the Authority is satisfied that either by reason of an unfavourable claim experience or because of sharp increase in the volume of the business, or for any other reason, compliance with the provisions of this sub-section would cause undue hardship to the insurer, the Authority may direct, for such period and subject to such conditions, such solvency margin not being less than the lower of the amount mentioned in sub-clause (i) or sub-clause (ii) above, as the case may be.

Explanation - For the purpose of this sub-section, the expressions -

(i) "mathematical reserves" means the provisions made by an insurer to cover liabilities (excluding liabilities which have fallen due and liabilities arising from the deposit back arrangement in relation to any poilicy whereby an amount is deposited by re-insurer with the cedant) arising under or in connection with policies or contracts for life insurance business. Mathematical reserves also include specific provision for adverse deviations of the bases, such as mortality and morbidity rates, interest rates and expense rates, and explicit provisions made in the valuation of liabilities, in accordance with the regulations made by the Authority for this purpose;

(ii) "net incurred claims" means the average of the net incurred claims during the specified period of not exceeding three preceding financial years;

(iii) "sum at risk" in relation to a life insurance policy, means a sum which is -

(a) in any case in which an amount is payable in consequence of death other than a case falling within sub-clause (b) below, the amount payable on death, and

(b) in any case in which the benefit under the policy in question consist of the making, in consequence of death, of the payments of annuity, payment of sum by instalments or any other kind of periodic payments, the present value of that benefit, less in either case the mathematical reserves in respect of the relevant policies.";

(c) after sub-section (2), insert the following :

"(2A) If, at any time an insurer does not maintain the required solvency margin in accordance with the provisions of this section, he shall, in accordance with the directions issued by the Authority, submit a financial plan, indicating a plan of action to correct the deficiency to the Authority within a specified period not exceeding three months.

(2B) An insurer who has submitted a plan under sub-section (2A) to the Authority shall propose modifications to the plan if the Authority considers it inadequate, and shall give effect to any plan accepted by the Authority as adequate.

(2C) An insurer who does not comply with the provisions of sub-section (2A) shall be deemed to be insolvent and may be wound up the Court.";

(d) after sub-section (6); insert the following :-

"(7) Every insurer shall furnish to the Authority with his returns under section 15 or section 16, as the case may be, in case of life insurance business a statement certified by an actuary approved by the authority, and in case of general insurance business a statement certified by an auditor approved by the Authority, of the required solvency margin maintained by the insurer in the manner required by sub-section (1A).".

References :

Study on Audit of companies carrying on General Insurance Business published by the Institute of Chartered Accountants of India; Insurance Act, 1938; General Insurance (Nationalisation) Act, 1972; Life Insurance Corporation Act, 1956; and Insurance Regulatory and Development Authority Act, 1999, Insurance Regulatory and Development Authority Regulations, 2002 .

Self Examination Questions

I. Objective Type Questions

1. Liabilities under the existing policies are determined by ________valuation in case of life insurance.
   (a) Actuarial
   (b) Fair
   (c) Average
   (d) Surrender
2. In fire insurance business ______ percentage of premium income is carried forward as provision for and the balance is transferred to profit and loss account.
   (a) 100%
   (b) 50%
   (c) 25%
   (d) 10%
3. Insurance business is controlled by
   (a) Insurance Act, 1938
   (b) Insurance Rules, 1939
   (c) IRDA Regulations, 2002
   (d) All of the above
4. In marine insurance business ______ percentage of premium income is carried forward as provision for and the balance is transferred to profit and loss account.
   (a) 100%
   (b) 50%
   (c) 25%
   (d) 10%

[**Answer 1** (a); **2** (b); **3** (d); **4** (a)]

II. Short Answer Type Questions

Write short notes on:

5. Reinsurance.

6. Claims.
7. Surrender Value.
8. Marine Insurance.
9. Paid-up policy?

III. Long Answer Type Questions

10. How will you distinguish life insurance from other forms of insurance business.
11. Explain briefly the requirements of the Insurance Act, 1938 regarding final accounts of insurance companies.

UNIT - 2 : ACCOUNTING TECHNIQUE OF GENERAL INSURANCE BUSINESS

Learning Objectives

After studying this unit, you will be able to:

- Understand the issues involved in the general insurance and learn the books of accounts/records which should be maintained at the divisional office of a general insurance company.
- Familiarize with the format of claim statement and try to understand how to compile the claim provisions.
- Understand the meaning of claims paid, co-insurance, outstanding premium and commission. Insurance companies debit all management expenses to a control account in the general ledger. Learn the technique of accounting of the management expenses and analysis thereof.
- Be familiar with the details of loans and investments of an insurance business and the books and records normally maintained in the investment department of an insurance company.
- Learn the technique of creating unexpired risks reserve in case of fire, marine, and miscellaneous insurance business.
- Understand the concept of re-insurance

2.1 FUNCTIONAL DIVISIONS AND BOOKS OF ACCOUNTS MAINTAINED THEREIN

Considering the nature and spread of the general insurance business, the four subsidiaries of the General Insurance Corporation operate through their Head Offices, Regional/Area Offices, Divisions and Branches attached thereto.

The most important part of the business operations comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms these operations get translated into—

(a) the receipt/recording of premium income; and

(b) the recording and settlement of claims for losses.

The business operations stated above are essentially confined to the divisional offices and the branches attached to these divisions. The accounting for these operations in these offices involve recording of premium income and provisions and payments in respect of claims under policies. Transactions related to operations at the branches are communicated for accounting thereof at the divisions. Generally, separate bank accounts are maintained for premium collections and for disbursement of expenditure. Normally, collections are transmitted to the relevant controlling office and the concerned account is not normally operated upon for expenditure etc. The branches of the divisions submit adequate information and evidence of transactions relating to their operations. The returns from the branches will include all transactions by way of documents relating to premium received, claims provisions and payments and operation of bank accounts.

The following books of account/records are normally maintained at a divisional office :

(i) Cash Receipt Book.

(ii) Cash Disbursement Book.

(iii) Dishonoured Cheque Register.

(iv) State Cheque Register.

(v) Daily Cash Balance Book.

(vi) Claims Disbursement Book.

(vii) Premium Register.

(viii) Bank Transfer Journal.

(ix) Journal.

(x) Summary Books for incorporation of Branch Returns (Cash Receipt Statements, Cash Disbursement Statements and Premium Register after these are duly checked).

(xi) General Ledger.

(xii) Sub-Ledgers.

(xiii) Register for Analysis of Management Expenses.

(xiv) Cash Receipts, Cash Disbursement Vouchers and Journal Vouchers.

(xv) Remittances Received Register.

(xvi) Salvage Register.

(xvii) Claims Recovery Register.

(xviii) Stationary Register.

(xix) Trunk Call Register.

(xx) Assets Register.

(xxi) Policy Stamp Register.

(xxii) Excess/Shortage Register.

(xxiii) Co-insurers Register.

Other major areas of accounting involve accounting for investments, reinsurance and other administrative matters which are dealt with at the Head Office.

2.2 CLAIMS PROVISION AT DIVISIONAL OFFICES

The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims.

Every division prepares a claims statement in the format given on the next page.

To cover the possibility of errors in judgement in estimation or in cases of under-estimation of liability (where full details are not available) as also for the possibility of liability not being considered for claims incurred but not reported due to the nature of risks being such (e.g., where communication is made after a considerable time lag or after the cut-off date for preparation of final accounts) the company at its head office makes an additional provision over and above that made by Divisions/Branches on the Divisional Auditors' Reports. Such liability is presently being cushioned to the extent of 5.5% in respect of Fire, Marine and Miscellaneous business (excluding motor, engineering, aviation, hull and credit guarantee) and 10.5% for motor and engineering business.

In view of the above, total of outstanding claims comprises the estimated liability recorded at the Divisions/Branches and the further provision made on this account at head office. This provision is subject to the amount to be adjusted for re-insurances, which are dealt with at head office.

2.3 CLAIMS PAID

For each class of business, the insurance companies have to disclose, in the relevant revenue accounts, claims paid separately. The divisional offices first ascertain the genuineness of the claim and ensure completion of the necessary formalities to enable the settlement to be made. Relevant evidence in respect of each claim is retained in each claim file and the liability is discharged after obtaining sanction of the relevant authority on the basis of amounts involved.

The divisional offices are expected to submit to the Head Office, for re-insurance adjustments, statements at regular intervals as to claims paid or provided for. Sometimes a year-end statement is also prepared showing month-wise figures so communicated.

2.4 CO-INSURANCE

In cases of large risks the business is shared between more than one insurer under co-insurance arrangements at agreed percentages. The leading insurer issues the documents, collects premium and settles claims. Statements of Account are rendered by the leading insurer to the other co-insurers. Accounting for premium, claims etc. under co-insurance is done in the same manner as that of the direct business except in respect of the following peculiar features.

Incoming Co-insurance

(i) *Premium* - The co-insurer books the premium based on the statement received from the leading insurer usually by issuing dummy documents. Entries are made in the Premium Register from which the Premium Account is credited and the Leading Insurer Company's Account debited. In case the statement is not received, the premium is accounted for on the basis of advices to ensure that all premium in respect of risk assumed in any year is booked in the same year; share of premium relatable to further extension/endorsements on policies by the leading insurer are also accounted for on the basis of subsequent advices. Reference to the relevant communications should be made from the concerned companies to ensure that premium collected by them and attributable to the company is recorded.

(ii) *Claims Provisions* – Refer para 2.2.

(iii) *Claims Paid* - Normally, on the basis of claims paid, advices received from the leading insurer, the Claims Paid Account is debited with a credit to the co-insurer. All such advices are entered into the Claims Paid Register. It is a practice to treat all claims paid advices relating to the accounting year received upto 31st January of the subsequent year from leading insurer as claims paid.

Outgoing Co-insurance

The share of the insurer only for both premium and claims has to be accounted under respective accounts. The share of other co-insurers is credited or debited, as the case may be, to their personal accounts and not routed through revenue accounts.

2.5 OUTSTANDING PREMIUM

This should normally comprise amounts due for uncollected premium where the company is allowed relaxation to the provisions of Section 64VB of the Insurance Act, 1938. The outstanding balances are expected to be temporarily outstanding and should be recovered within the stipulated period after the year-end. There may however be cases of premium otherwise receivable and due but which remains uncollected at the year-end.

(a) *Bank guarantee limits available* - Premium in respect of risk accepted under Bank Guarantee and Cash Deposit received either directly or through agents is accounted for with reference to the limits available. Normally, monthly statements are prepared and submitted to every party and the balances of outstanding premium are recovered before the close of the following month. Outstanding premium in excess of bank guarantee available should be reported.

(b) *Cash Deposit* - The balance of this account is always credit except in cases where the premium due exceeds the cash deposits resulting in debit balance recoverable from the party. Debit balance in the cash deposit account is shown separately since they are classified separately with the debit balance under outstanding premium on the assets side of the balance sheet.

2.6 COMMISSION

Section 40A(3) of the Insurance Act, 1938, deals with and prescribes the basis and rates of commission payable to agents. However, under the provisions of General Insurance Nominalisation Act, the G.I.C. is empowered to regulate the commission structure.

It may be noted that all expenses of management are debited to a control account in the general ledger under "Expenses of Management" with a supporting subsidiary ledger viz., "Analysis of Management Expenses" wherein expenses for each classified category are posted and reconciled with the control account. Management Expenses Accounts Classification Schedule is normally annexed to the Trial Balance and forms a part thereof. Such expenses are shown separately under fire, marine and miscellaneous revenue accounts apportioned as recommended by the Guidelines framed by the General Insurance Corporation for this purpose, and as to the basis of such apportionment, a note is appended to the accounts. Provision for outstanding expenses is made at the divisional office level.

2.7 LOANS

Part II of the First Schedule to the Insurance Act, 1938, requires the following items to be disclosed in the balance sheet :

Loans :

On mortgages of property within India.

On mortgages of property outside India.

On security of municipal and other public rates.

On stocks and shares.

On Insurer's policies within their surrender value.

On personal security.

To Subsidiary Companies (other than Reversionary).

Reversions and Life Interests purchased.

Loans on Reversions and Life Interests.

Debentures and Debenture stocks of Subsidiary Reversionary Companies.

Ordinary stocks and share of Subsidiary Reversionary Companies.

Loans to Subsidiary Reversionary Companies.

Besides the above items the present practice is also to disclose loans to industrial undertakings in India on consortium basis with the GIC and the four subsidiary companies and/or other financial institutions. Term loans may often be preceded by bridge loans to such undertakings pending completion of all formalities.

Except for housing and other loans to staff which may be recorded at the Divisions/Regional level other loans are usually dealt with at Head Office.

2.8 INVESTMENTS

Investments in general insurance companies are governed by the provisions of Section 27B of the Insurance Act, 1938 as well as by the guidelines issued from time to time by the Ministry of Finance through General Insurance Corporation of India.

The various types of investments normally included in the Balance Sheet are given below:

Deposit with the Reserve Bank of India (Securities to be specified)

Indian Government Securities/State Government Securities

British, British Colonial and British Dominion Government Securities

Foreign Government Securities

Indian Municipal Securities

British and Colonial Securities/Foreign Securities

Bonds, Debentures, Stocks and other securities whereon Interest is guaranteed by the Indian Government or State Government

Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the British or any Colonial Government

Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by any Foreign Government

Debentures of any Railway in India

Debentures of any Railway out of India

Preference or guaranteed Shares of any Railway in India

Preference or guaranteed Shares of any Railway out of India

Railway Ordinary Stocks (*i*) in India (*ii*) out of India

Other Debentures and Debenture Stock of Companies incorporated (*i*) in India (*ii*) out of India

Other Guaranteed and Preference Stocks and Shares of Companies incorporated (*i*) in India (*ii*) out of India

Other Ordinary Stocks and Shares of Companies incorporated (*i*) in India (*ii*) out of India

Holdings in Subsidiary Companies.

As per the Guidelines presently applicable, the investible funds have to be invested on the following pattern :

(i)	Central Government Securities	—	25 % of annual accretion
(ii)	State Government Securities	—	10% of annual accretion
(iii)	Housing Loans		
	(*a*) To HUDCO	—	15% of annual accretion
	(*b*) State Governments for housing	—	20% of annual accretion
(iv)	Market investment	—	30% of annual accretion

On the basis of estimates made at the beginning of the year, the investments are made accordingly in each category. The estimates are reviewed and revised periodically if necessary.

The following books and records are normally maintained in the Investment Department of the Head Office of a company carrying on general insurance business.

(1) Contracts (Bought/Sold Notes)

(2) Copies of the Delivery Instructions

(3) Purchase Registers

(4) Application Money Registers

(5) Allotment and Call Money Registers

(6) Rights Issue/Bonus Issue Registers

(7) Sales Redemption Registers

(8) Term Loans Registers

(9) Fixed Deposits/Participation Certificates/Bills Register

(10) Underwriting Registers

(11) Dividend Reconciliation Register

(12) Interest Reconciliation Register

(13) Safe-custody Receipts issued by banks

(14) Cash Book/Bank Book

(15) Investments sub-ledgers

(16) General Ledgers

(17) Investment Schedules, classified as to nature of investments.

2.9 UNEXPIRED RISKS RESERVE

The need for unexpired risks reserve arises from the fact that all policies are renewed annually except in specific cases where short period policies are issued. Since the insurers close their accounts on a particular date, i.e. 31st December, not all risks under policies expire on that date. Many policies normally extend beyond this date into the following year during which risks continue. In other words, at the closing date, there is unexpired liability under various policies, which may occur during the remaining term of the policy beyond the year end.

The effort involved in calculating unexpired portion of premium under each policy is very time consuming. Therefore, a simple formula to derive a percentage of premium income to be allocated to reserve for unexpired risks is adopted.

According to the requirements of the Insurance Act, it is sufficient if the provision is made for unexpired risks at 50 per cent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 per cent. It may be mentioned that the insurance companies are governed by the provisions of Section 44 of the Income-tax Act, 1961. In this regard, Rule 5 of the First Schedule to the Income-tax Rules—computation of Profit & Loss of General Insurance Business—provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the said Rules. According to this Rule, the insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine insurance business. In view of this the reserves are created at the rates allowed under the Income-tax Act.

2.10 REINSURANCE

Reinsurance plays an important role in the insurance business of virtually every type. The service provided by re-insurer is similar to that provided by the insurance companies to their policy holders. In general insurance there are risks which, because of their magnitude or nature, one insurance company cannot afford to cover, e.g., aviation insurance. Generally, in such cases, an insurance company insures the whole risk itself and lays off the amount it has accepted to other insurance of reinsurance companies, retaining only that much risk which it can absorb.

A reinsurance transaction may thus be defined as an agreement between a ‘ceding company’ and a ‘re-insurer’ whereby the former agrees to ‘cede’ and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement.

A ‘ceding company’ is the original insurance company which has accepted the risk and has agreed to ‘cede’ or pass on that risk to another insurance company or a reinsurance company. It may however be emphasized that the original insured does not acquire any right under a reinsurance contact. In the event of loss, therefore, the insured’s claim for full amount is against the original insurer.

Since reinsurance is a form of insurance, the principles of insurance business such as ‘utmost good faith’, ‘insurable interest’ and ‘indemnity’ equally apply to reinsurance contracts also.

Broadly-speaking, there are two types of reinsurance contracts, namely, Facultative Reinsurance and Treaty Reinsurance. These are discussed in brief in the subsequent paragraphs.

Facultative Reinsurance - It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in a reinsurance policy. This is the oldest method of reinsurance and it necessitates consideration of each risk separately. Each transaction under Facultative Reinsurance has to be negotiated individually and each party to the transaction has a free choice, i.e. for the ceding company to offer and the reinsurer to accept. The main drawbacks of this type of insurance is the volume of work involved and time taken to cover the risk.

Treaty Insurance

Under this type of reinsurance a Treaty agreement is entered into between ceding company and the re-insurer(s) whereby the reinsurances are within the limits of the Treaty. These limits can be monetary, geographical, section of business, etc. Under this contract it is obligatory for the re-insurer to accept all risks within the scope of this Treaty and it is obligatory for the ceding company to cede risks in accordance with the terms of the Treaty.

Treaties can also be divided into two categories, viz. proportional treaties and non-proportional treaties.

Self-examination Questions

I. Objective Type Questions

1. For the settlement of claim, insurance company

    (a) ascertains the genuineness of the claim

(b) ensures completion of the necessary formalities

(c) Both (a) & (b)

(d) None of the above.

[**Answer** (c)]

II. Short Answer Type Questions

Write Short Notes on:

2. Expenses of management of a general insurance business.
3. Outstanding premiums.
4. Unexpired risks reserve.
5. What do you mean by reinsurance ?

III. Long Answer Type Questions

6. Try to identify the book of accounts maintained at the divisional office of a general insurance company.
7. Why is it necessary to create provision of claims at the Head Office over and above the provisions at the divisional level?
8. What is Co-insurance? What accounting treatment is necessary for adjustment of claims covered under co-insurance?

UNIT – 3 : FINANCIAL STATEMENTS OF INSURANCE COMPANIES

Learning Objectives

After studying this unit, you will be able to:

- Prepare financial statements of insurance companies carrying on life insurance business.
- Prepare financial statements of insurance companies carrying on general insurance
- Understand the requirements of IRDA Regulations, 2002.

3.1 INTRODUCTION

Insurance Regulatory and Development Authority, after consulation with the Insurance Advisory Committee, in exercise of the powers conferred by section 114A of the Insurance Act, 1938 (4 of 1938) published the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations 2000 in the official Gazettee on 14th August, 2000. Recently that Guidelines are revised and a new set of guidelines have been issued vide notification dated 30th March, 2002[www.irdaindia.org].As per the IRDA Guidelines, an insurer carrying on life insurance business shall comply with the requirements given in Schedule A, an insurer carrying on general insurance business shall comply with the requirements given in Schedule B and the report of the auditors shall be in conformity with the requirements of Schedule C.

3.2 STRUCTURE OF SCHEDULES A AND B:

The following table depicts the structure of schedules A and B given under IRDA regulations:

Schedule A for Life Insurance Business	**Schedule B for General Insurance Business**
Part I: Accounting Principles for preparation of financial statement	Part I: Accounting Principles for preparation of financial statements
Part II: Disclosures forming part of Financial Statements	Part II: Disclosures forming part of Financial Statement
Part III: General Instructions for preparation of financial statements	Part III: General Instructions for preparation of financial statements.
Part IV: Contents of Management Report	Part IV: Contents of Management Report
Part V: Preparation of Financial statements	Part V: Preparation of financial statements.

Form A-RA: Revenue Account	Form B-RA: Revenue Account
Form A-PL: Profit and Loss Account	Form B-PL: Profit and Loss Account
Form A-BS: Balance sheet and 15 Schedules forming part of financial statements	Form B-BS: Balance Sheet and 15 Schedules forming part of financial statements

3.3 FINANCIAL STATEMENTS

Life Insurance Business

The insurance company carrying life insurance business is required to prepare Balance sheet form A – BS Revenue account [Policy holders' account] Form A- RA Profit and loss account form A-PL. These forms have been given in the IRDA Regulations, 2002.

No form has been specified for cash flow statement.

General Insurance Business

The insurance company carrying on general insurance business is required to prepare Balance sheet form B – BS Revenue account [Policy holders' account] Form B- RA Profit and loss account form B-PL. These forms have been given in the IRDA Regulations, 2002.

No form has been specified for cash flow statement.

3.4 IRDA REGULATIONS, 2002

The detailed contents of the IRDA Regulations, 2002 have been given below:

THE INSURANCE REGULATORY AND DEVELOPMENT AUTHORITY (PREPARATION OF FINANCIAL STATEMENTS AND AUDITOR'S REPORT OF INSURANCE COMPANIES) REGULATIONS, 2002

NOTIFICATION

30th March, 2002.

In exercise of the powers conferred by section 114A of the Insurance Act, 1938, (4 of 1938),and in suppression of the The Insurance Regulatory And Development Authority (Preparation Of Financial Statements And Auditor's Report Of Insurance Companies) Regulations, 2000, Authority, in consultation with the Insurance Advisory Committee, hereby makes the following regulations, namely:-

1. Short title and commencement.----(1) These regulations may be called the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002.

(2) They shall come into force from the date of their publication in the Official Gazette.

(3) On and from the commencement of these regulations, The Insurance Regulatory And Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000 shall stand superceded, except as respects things done or omitted to be done thereunder.

2. Definitions.—(1) In these regulations, unless the context otherwise requires ---

(a) "*Act*" means the Insurance Act, 1938 (4 of 1938);

(b) "*Authority*" means the Insurance Regulatory and Development Authority established under sub-section (1) of section 3 of the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999);

(c) All words and expressions used herein and not defined but defined in the Insurance Act, 1938 (4 of 1938), or Insurance Regulatory and Development Authority Act, 1999 (41 of 1999), or Companies Act, 1956 (1 of 1956), shall have the meanings respectively assigned to them in those Acts.

3. Preparation of financial statements, management report and auditor's report.----(1) An insurer carrying on life insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule A.

(2) An insurer carrying on general insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule B:

Provided that this sub-regulation shall apply, *mutatis mutandis,* to reinsurers, until separate regulations are made.

(3) The report of the auditors on the financial statements of every insurer and reinsurer shall be in conformity with the requirements of Schedule C, or as near thereto as the circumstances permit.

(4) The Authority may, from time to time, issue separate directions/ guidelines in the matter of appointment, continuance or removal of auditors of an insurer or reinsurer, as the case may be, and such directions/ guidelines may include prescriptions regarding qualifications and experience of auditors, their rotation, period of appointment, etc as may be deemed necessary by the Authority.

SCHEDULE A

PART I

Accounting principles for preparation of financial statements

1. Applicability of Accounting Standards---Every Balance Sheet, Revenue Account [Policyholders' Account], Receipts and Payments Account [Cash Flow statement] and Profit and Loss Account [Shareholders' Account] of an insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except that:

1. Accounting Standard 3 (AS 3) – Cash Flow Statements – Cash Flow Statement shall be prepared only under the Direct Method.
2. Accounting Standard 17 (AS 17) - Segment Reporting – shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

2. Premium – Premium shall be recognised as income when due. For linked business the due date for payment may be taken as the date when the associated units are created.

3. Acquisition Costs – Acquisition costs, if any, shall be expensed in the period in which they are incurred.

Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e., commencement of risk).

4. Claims Cost –The ultimate cost of claims shall comprise the policy benefit amount and specific claims settlement costs, wherever applicable.

5. Actuarial Valuation – Liability for Life Policies – The estimation of liability against life policies shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.

The liability shall be so calculated that together with future premium payments and investment income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

6. Procedure to determine value of investments. – An insurer shall determine the values of investments in the following manner:-

(a) **Real Estate – Investment Property –** The value of investment property shall be determined at historical cost, subject to revaluation at least once in every three years. The change in the carrying amount of the investment property shall be taken to Revaluation Reserve.

The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

Gains/ losses arising due to changes in the carrying amount of real estate shall be taken to equity under 'Revaluation Reserve'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the carrying amount previously recognised in equity under the heading 'Revaluation Reserve' in respect of a particular property and being recycled to the relevant Revenue Account or Profit and Loss Account on sale of that property.

The bases for revaluation shall be disclosed in the notes to accounts. The Authority may issue directions specifying the amount to be released from the revaluation reserve for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the Authority's direction, no other amount shall be distributed to shareholders out of Revaluation Reserve Account.

An impairment loss shall be recognised as an expense in the Revenue/Profit and Loss Account immediately, unless the asset is carried at re-valued amount. Any impairment loss of a re-valued asset shall be treated as a revaluation decrease of that asset and if the impairment loss exceeds the corresponding revaluation reserve, such excess shall be recognised as an expense in the Revenue/Profit and Loss Account.

(b) **Debt Securities – Debt securities,** including government securities and redeemable preference shares, shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) **Equity Securities and Derivative Instruments that are traded in active markets –** Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies)/ derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogenous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealised gains/ losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account". The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading 'Fair Value Change Account' in respect of a particular security and being recycled to the relevant Revenue Account or Profit and Loss Account on actual sale of that listed security.

The Authority may issue directions specifying the amount to be released from the Fair Value Change Account for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the Authority's prescription, no other amount shall be distributed to shareholders out of Fair Value Change Account. Also, any debit balance in Fair Value Change Account shall be reduced from profit/free reserves while declaring dividends.

The insurer shall assess, on each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognised as an expense in Revenue/Profit and Loss Account to the extent of the difference between the re-measured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognised as expense in Revenue/Profit and Loss Account. Any reversal of impairment loss, earlier recognised in Revenue/Profit and Loss Account shall be recognised in Revenue/Profit and Loss Account.

(a) **Unlisted and other than actively traded Equity Securities and Derivative Instruments –** Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active markets shall be measured at historical cost. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as "thinly traded".

7. Loans – Loans shall be measured at historical cost subject to impairment provisions.The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India, that apply to companies and financial institutions.

8. Linked Business – The accounting principles used for valuation of investments are to be consistent with principles enumerated above. A separate set of financial statements, for each segregated fund of the linked businesses, shall be annexed.

Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/ gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.

9. Funds for Future Appropriation – The funds for future appropriation shall be presented separately.

The funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

PART II

Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:
   (a) Partly-paid up investments
   (2) Underwriting commitments outstanding
   (3) Claims, other than those under policies, not acknowledged as debts
   (4) Guarantees given by or on behalf of the company
   (5) Statutory demands/liabilities in dispute, not provided for
   (6) Reinsurance Obligations to the extent no provided for in accounts
   (7) Others (to be specified).
2. Actuarial assumptions for valuation of liabilities for life policies in force.
3. Encumbrances to assets of the company in and outside India.
4. Commitments made and outstanding for Loans, Investments and Fixed Assets.
5. Basis of amortisation of debt securities.
6. Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.
7. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending;
   (b) Sales where payments are overdue.
8. Operating expenses relating to insurance business: basis of allocation of expenditure to various segments of business.
9. Computation of managerial remuneration.
10. Historical costs of those investments valued on fair value basis.
11. Basis of revaluation of investment property.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies, followed by the insurer, shall be stated in the manner required under Accounting Standard AS 1 issued by the ICAI.
2. Any departure from the accounting policies shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India;
2. Segregation into performing/ non performing investments for purpose of income recognition as per the directions, if any, issued by the Authority;
3. Assets to the extent required to be deposited under local laws or otherwise encumbered in or outside India;
4. Percentage of business sector-wise;
5. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority;
6. Bases of allocation of investments and income thereon between Policyholders' Account and Shareholders' Account;
7. Accounting Ratios as may be prescribed by the Authority.

PART III

General instructions for preparation of Financial Statements

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account, Profit and Loss Account and Receipts and Payments Account shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount, the amount of income tax deducted at source should be included under 'advance taxes paid' and taxes deducted at source.

1. (I) For the purposes of financial statements, unless the context otherwise requires -

   (a) the expression 'provision' shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

   (b) the expression 'reserve' shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability or loss;

   (c) the expression 'capital reserve' shall not include any amount regarded as free for distribution through the profit and loss account; and the expression 'revenue reserve' shall mean any reserve other than a capital reserve;

   (d) The expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

   (II) Where:

   (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

   (b) any amount retained by way of providing for any known liability or loss, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not provision.

5. The company shall make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

6. Extent of risk retained and re-insured shall be separately disclosed.

7. Any debit balance of the Profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance, if any, shall be shown separately.

PART IV

Contents of Management Report

There shall be attached to the financial statements, a management report containing, *inter alia*, the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority;

2. Certification that all the dues payable to the statutory authorities have been duly paid;

3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;

4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India;

5. Confirmation that the required solvency margins have been maintained;

6. Certification to the effect that the values of all the assets have been reviewed on the date of the Balance Sheet and that in his (insurer's) belief the assets set forth in the Balance-sheets are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings – " Loans", " Investments", "Agents balances", "Outstanding Premiums", "Interest, Dividends and Rents outstanding", "Interest, Dividends and Rents accruing but not due", "Amounts due from other persons or Bodies carrying on insurance business", " Sundry Debtors", " Bills Receivable", " Cash" and the several items specified under "Other Accounts";

7. Certification to the effect that no part of the life insurance fund has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investment of the life insurance funds;

8. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same;

9. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;

10. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;

11. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown;

12. Review of asset quality and performance of investment in terms of portfolios, i.e., separately in terms of real estate, loans, investments, etc.

13. A responsibility statement indicating therein that:

    (a) in the preparation of financial statements, the applicable accounting standards, principles and policies have been followed along with proper explanations relating to material departures, if any;

(b) the management has adopted accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the operating profit or loss and of the profit or loss of the company for the year;

(c) the management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act 1938 (4 of 1938) / Companies Act, 1956 (1 of 1956), for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;

(d) the management has prepared the financial statements on a going concern basis;

(e) the management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.

14. A schedule of payments, which have been made to individuals, firms, companies and organisations in which Directors of the insurer are interested.

PART V

Preparation of Financial Statements

1. An insurer shall prepare the Revenue Account [Policyholders' Account], Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form A-RA, Form A-PL and Form A-BS, as prescribed in this Part, or as near thereto as the circumstances permit**.**

Provided that an insurer shall prepare Revenue Account and Balance Sheet for the under mentioned businesses separately and to that extent the application of AS 17 shall stand modified:-

(a) Participating policies and Non-participating policies;

(b) (i) Linked business [As defined in regulation 2 (i) of the IRDA (Registration of Indian Insurance Companies) Regulations , 2000]

(ii) Non-Linked business separately for Ordinary Life, General Annuity, pensions and Health Insurance;

Business within India and business outside India.

2. An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3 – "Cash Flow Statement" issued by the ICAI.

FORM A-RA

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

Policyholders' Account (Technical Account)

	Particulars	Schedule	Current Year	Previous Year
			(Rs.'000)	(Rs.'000).
	Premiums earned – net			
	(a) Premium (b) Reinsurance ceded (c) Reinsurance accepted-	1		
	Income from Investments			
	(a) Interest, Dividends & Rent – Gross (b) Profit on sale/redemption of investments (c) (Loss on sale/ redemption of investments) (d) Transfer/Gain on revaluation/change in fair value*			
	Other Income (to be specified)			
	TOTAL (A)			
	Commission	2		
	Operating Expenses related to Insurance Business	3		
	Provision for doubtful debts			
	Bad debts written off			
	Provision for Tax			

	Provisions (other than taxation)			
	(a) For diminution in the value of investments (Net) (b) Others (to be specified)			
	TOTAL (B)			
	Benefits Paid (Net)	**4**		
	Interim Bonuses Paid			
	Change in valuation of liability in respect of life policies (a) Gross** (b) Amount ceded in Reinsurance (c) Amount accepted in Reinsurance			
	TOTAL (C)			
	SURPLUS/ (DEFICIT) (D) =(A)-(B)-(C)			
	APPROPRIATIONS			
	Transfer to Shareholders' Account			
	Transfer to Other Reserves (to be specified)			
	Balance being Funds for Future Appropriations			
	TOTAL (D)			

Notes:

* *Represents the deemed realised gain as per norms specified by the Authority.*

** *represents Mathematical Reserves after allocation of bonus*

The total surplus shall be disclosed separately with the following details:

(a) Interim Bonuses Paid:

(b) Allocation of Bonus to policyholders:

(c) Surplus shown in the Revenue Account:

(d) Total Surplus: [(a)+(b)+(c)].

See Notes appended at the end of Form A-PL

FORM A-PL

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

Shareholders' Account (Non-technical Account)

	Particulars	Schedule	Current Year	Previous Year
			(Rs.'000).	*(Rs.'000).*
	Amounts transferred from/to the Policyholders Account (Technical Account)			
	Income From Investments			
	(a) Interest, Dividends & Rent – Gross (b) Profit on sale/redemption of investments (c) (Loss on sale/ redemption of investments)			
	Other Income (To be specified)			
	TOTAL (A)			
	Expense other than those directly related to the insurance business			
	Bad debts written off			
	Provisions (Other than taxation)			
	(a) For diminution in the value of investments (Net) (b) Provision for doubtful debts (c) Others (to be specified)			
	TOTAL (B)			

	Profit/ (Loss) before tax			
	Provision for Taxation			
	Profit / (Loss) after tax			
	APPROPRIATIONS			
	(a) Balance at the beginning of the year. (b) Interim dividends paid during the year (c) Proposed final dividend (d) Dividend distribution on tax (e) Transfer to reserves/ other accounts (to be specified)			
	Profit carried ------------to the Balance Sheet			

Notes to Form A-RA and A-PL.

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance premiums.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end,.

(d) Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs.5,00,000 whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(g) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source".

(h) Income from rent shall include only the realised rent. It shall not include any notional rent.

FORM A-BS

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

BALANCE SHEET AS AT 31ST MARCH, 20____.

		Schedule	Current Year	Previous Year
			(Rs.'000).	*(Rs.'000).*
	SOURCES OF FUNDS			
	SHAREHOLDERS' FUNDS:			
	SHARE CAPITAL	**5**		
	RESERVES AND SURPLUS	**6**		
	CREDIT/[DEBIT] FAIR VALUE CHANGE ACCOUNT			
	Sub-Total			
	BORROWINGS	**7**		
	POLICYHOLDERS' FUNDS:			
	CREDIT/[DEBIT] FAIR VALUE CHANGE ACCOUNT			
	POLICY LIABILITIES			
	INSURANCE RESERVES			
	PROVISION FOR LINKED LIABILITIES			
	Sub-Total			
	FUNDS FOR FUTURE APPROPRIATIONS			
	TOTAL			

	APPLICATION OF FUNDS			
	INVESTMENTS			
	Shareholders'	**8**		
	Policyholders'	**8A**		
	ASSETS HELD TO COVER LINKED LIABILITIES	**8B**		
	LOANS	**9**		
	FIXED ASSETS	**10**		
	CURRENT ASSETS			
	Cash and Bank Balances	**11**		
	Advances and Other Assets	**12**		
	Sub-Total (A)			
	CURRENT LIABILITIES	**13**		
	PROVISIONS	**14**		
	Sub-Total (B)			
	NET CURRENT ASSETS (C) = (A – B)			
	MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)	**15**		
	DEBIT BALANCE IN PROFIT & LOSS ACCOUNT (Shareholders' Account)			
	TOTAL			

CONTINGENT LIABILITIES

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Partly paid-up investments		

2.	Claims, other than against policies, not acknowledged as debts by the company		
3.	Underwriting commitments outstanding (in respect of shares and securities)		
4.	Guarantees given by or on behalf of the Company		
5.	Statutory demands/ liabilities in dispute, not provided for		
6.	Reinsurance obligations to the extent not provided for in accounts		
7.	Others (to be specified)		
	TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE – 1

PREMIUM

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1	First year premiums		
2	Renewal Premiums		
3	Single Premiums		
	TOTAL PREMIUM		

SCHEDULE- 2

COMMISSION EXPENSES

Particulars	Current Year	Previous Year
	(Rs.'000)	*(Rs.'000)*
Commission paid		
Direct – First year premiums - Renewal premiums - Single premiums Add: Commission on Re-insurance Accepted Less: Commission on Re-insurance Ceded		
Net Commission		

Note: The profit/ commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE – 3

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

	Particulars	Current Year	Previous Year
		(Rs.'000).	*(Rs.'000).*
1.	Employees' remuneration & welfare benefits		
2	Travel, conveyance and vehicle running expenses		
3	Training expenses		
4	Rents, rates & taxes		
5	Repairs		
6	Printing & stationery		
7	Communication expenses		
8	Legal & professional charges		
9	Medical fees		
10	Auditors' fees, expenses etc		

	a) as auditor b) as adviser or in any other capacity, in respect of (i) Taxation matters (ii) Insurance matters (iii) Management services; and c) in any other capacity		
11	Advertisement and publicity		
12	Interest & Bank Charges		
13	Others (to be specified)		
14	Depreciation		
	TOTAL		

Note : Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs.5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE – 4

BENEFITS PAID [NET]

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
	1. Insurance Claims Claims by Death, Claims by Maturity, Annuities/Pension payment, Other benefits, specify		
	2. (Amount ceded in reinsurance): (a) Claims by Death, (b) Claims by Maturity, (c) Annuities/Pension payment, (d) Other benefits, specify		

	3. Amount accepted in reinsurance: (a) Claims by Death, (b) Claims by Maturity, (c) Annuities/Pension payment, (d) Other benefits, specify		
	TOTAL		

Notes:

(a) Claims include specific claims settlement costs, wherever applicable.

(b) Legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

SCHEDULE – 5

SHARE CAPITAL

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Authorised Capital		
	Equity Shares of Rs..... each		
2.	Issued Capital		
	Equity Shares of Rs. .....each		
3.	Subscribed Capital		
	Equity Shares of Rs.......each		
4.	Called-up Capital		
	Equity Shares of Rs. .....each		
	Less : Calls unpaid		
	Add : Shares forfeited (Amount originally paid up)		
	Less : Par value of Equity Shares bought back		

	Less : Preliminary Expenses Expenses including commission or brokerage on Underwriting or subscription of shares		
	TOTAL		

Notes:

(a) *Particulars of the different classes of capital should be separately stated.*

(b) *The amount capitalised on account of issue of bonus shares should be disclosed.*

(c) *In case any part of the capital is held by a holding company, the same should be separately disclosed.*

SCHEDULE – 5A

PATTERN OF SHAREHOLDING

[As certified by the Management]

Shareholder	**Current Year**		**Previous Year**	
	Number of Shares	**% of Holding**	**Number of Shares**	**% of Holding**
Promoters Indian Foreign				
Others				
TOTAL				

SCHEDULE – 6

RESERVES AND SURPLUS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	*(Rs.'000)*
1.	Capital Reserve		
2.	Capital Redemption Reserve		

3	Share Premium		
4.	Revaluation Reserve		
5.	General Reserves Less: Debit balance in Profit and Loss Account, if any Less: Amount utilized for Buy-back		
6.	Catastrophe Reserve		
7.	Other Reserves (to be specified)		
8.	Balance of profit in Profit and Loss Account		
	TOTAL		

Note: *Additions to and deductions from the reserves shall be disclosed under each of the specified heads.*

SCHEDULE - 7

BORROWINGS

	Particulars	Current Year	Previous Year
		(Rs.'000).	*(Rs.'000).*
1.	Debentures/ Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to be specified)		
	TOTAL		

Notes:

(a) *The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.*

(b) *Amounts due within 12 months from the date of Balance Sheet should be shown separately*

SCHEDULE- 8

INVESTMENTS-SHAREHOLDERS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	*(Rs.'000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares (aa) Equity (bb) Preference		

	(b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Note: See Notes appended at the end of Schedule- 8B

SCHEDULE- 8A

INVESTMENTS-POLICYHOLDERS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	*(Rs.'000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		

4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (a) Derivative Instruments (b) Debentures/ Bonds (c) Other Securities (to be specified) (d) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Note: See Notes appended at the end of Schedule- 8B

SCHEDULE- 8B

ASSETS HELD TO COVER LINKED LIABILITIES

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares		

	(aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Notes *(applicable to Schedules 8 and 8A & 8B):*

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) *Holding company and subsidiary shall be construed as defined in the Companies Act, 1956:*

(ii) *Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.*

(iii) *Joint control - is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.*

(iv) *Associate - is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.*

(v) *Significant influence (for the purpose of this schedule) -means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policymaking process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 percent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 percent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant* influence.

(b) *Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.*

(c) *Investment made out of Catastrophe reserve should be shown separately.*

(d) *Debt securities will be considered as "held to maturity" securities and will be measured at historical costs subject to amortisation*

(e) *Investment Property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.*

(f) *Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall* be classified as short-term investments

SCHEDULE - 9

LOANS

	Particulars	Current Year	Previous Year
		(Rs.'000).	*(Rs.'000).*
1.	SECURITY-WISE CLASSIFICATION		
	Secured		
	(a) On mortgage of property (aa) In India (bb) Outside India		
	(b) On Shares, Bonds, Govt. Securities, etc.		
	(c) Loans against policies		
	(d) Others (to be specified)		
	Unsecured		
	TOTAL		
2.	BORROWER-WISE CLASSIFICATION		
	(a) Central and State Governments		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Companies		
	(e) Loans against policies		
	(f) Others (to be specified)		
	TOTAL		
3.	PERFORMANCE-WISE CLASSIFICATION		
	(a) Loans classified as standard (aa) In India (bb) Outside India		

	(b) Non-standard loans less provisions (aa) In India (bb) Outside India		
	TOTAL		
4.	MATURITY-WISE CLASSIFICATION		
	(a) Short Term		
	(b) Long Term		
	TOTAL		

Notes:

(a) *Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.*

(b) *Provisions against non-performing loans shall be shown separately.*

(c) *The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.*

(d) *Loans considered doubtful and the amount of provision created against such loans shall* be disclosed.

SCHEDULE - 10

FIXED ASSETS

(Rs.'000)

Particulars	**Cost/ Gross Block**				**Depreciation**				**Net Block**	
	Opening	Additions	Deductions	Closing	Up to Last Year	For The Year	On Sales/ Adjust ments	To Date	As at year end	Previous Year
Goodwill										
Intangibles (specify)										

Land-Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work in progress										
Grand Total										
PREVIOUS YEAR										

Note:

Assets included in land, property and building above exclude Investment Properties as defined in note (e) to Schedule 8.

SCHEDULE- 11

CASH AND BANK BALANCES

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Cash (including cheques, drafts and stamps)		
2.	Bank Balances		
	(a) Deposit Accounts (aa) Short-term (due within 12 months of the date of Balance Sheet) (bb) Others (b) Current Accounts (c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks (b) With other Institutions		
4.	Others (to be specified)		
	TOTAL		
	Balances with non-scheduled banks included in 2 and 3 above		
	CASH & BANK BALANCES		
1	In India		
2	Outside India		
	TOTAL		

Note: Bank balance may include remittances in transit. If so, the nature and amount shall be separately stated.

SCHEDULE – 12

ADVANCES AND OTHER ASSETS

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
	ADVANCES		
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	TOTAL (A)		
	OTHER ASSETS		
1.	Income accrued on investments		
2.	Outstanding Premiums		
3.	Agents' Balances		
4.	Foreign Agencies Balances		
5	Due from other entities carrying on insurance business (including reinsures)		
6.	Due from subsidiaries/ holding company		
7.	Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938]		
8.	Others (to be specified)		
	TOTAL (B)		
	TOTAL (A+B)		

Notes:

(a) *The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.*

(b) *The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.*

(c) *Sundry debtors will be shown under item 8 (Others)*

SCHEDULE – 13

CURRENT LIABILITIES

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated premium		
6.	Sundry creditors		
7.	Due to subsidiaries/ holding company		
8.	Claims Outstanding		
9.	Annuities Due		
10.	Due to Officers/ Directors		
11.	Others (to be specified)		
	TOTAL		

SCHEDULE – 14

PROVISIONS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	For taxation (less payments and taxes deducted at source)		
2.	For proposed dividends		
3.	For dividend distribution tax		
4.	Others (to be specified)		
	TOTAL		

SCHEDULE – 15

MISCELLANEOUS EXPENDITURE

(To the extent not written off or adjusted)

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Discount Allowed in issue of shares/ debentures		
2.	Others (to be specified)		
	TOTAL		

Notes:

(a) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:

1 some benefit from the expenditure can reasonably be expected to be received in future, and

2 the amount of such benefit is reasonably determinable.

(b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

SCHEDULE B

PART I

Accounting principles for preparation of financial statements

1. Applicability of Accounting Standards---Every Balance Sheet, Receipts and Payments Account [Cash Flow statement] and Profit and Loss Account [Shareholders' Account] of the insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to the insurers carrying on general insurance business, except that:

1. Accounting Standard 3 (AS 3) – Cash Flow Statements – Cash Flow Statement shall be prepared only under the Direct Method.
2. Accounting Standard 13 (AS 13) – Accounting for Investments, shall not be applicable.
3. Accounting Standard 17 (AS 17) - Segment Reporting – shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

2. Premium--Premium shall be recognised as income over the contract period or the period of risk, whichever is appropriate. Premium received in advance, which represents premium income not relating to the current accounting period, shall be disclosed separately in the financial statements.

A reserve for unexpired risks shall be created as the amount representing that part of the premium written which is attributable to, and to be allocated to the succeeding accounting periods and shall not be less than as required under section 64 V(1) (ii) (b) of the Act.

Premium Received in Advance, which represents premium received prior to the commencement of the risk, shall be shown separately under the head '*Current Liabilities'* in the financial statements.

3. Premium Deficiency--Premium deficiency shall be recognised if the sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.

4. Acquisition Costs---Acquisition costs, if any, shall be expensed in the period in which they are incurred.

Acquisition costs are those costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e. commencement of risk).

5. Claims--The components of the ultimate cost of claims to an insurer comprise the claims under policies and specific claims settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies following a loss occurrence.

A liability for outstanding claims shall be brought to account in respect of both direct business and inward reinsurance business. The liability shall include: -

(a) Future payments in relation to unpaid reported claims;

(b) Claims Incurred But Not Reported (IBNR) including inadequate reserves [sometimes referred to as Claims Incurred But Not Enough Reported (IBNER)],

which will result in future cash/asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liability for outstanding claims at the beginning and at the end of the financial period.

The accounting estimate shall also include claims cost adjusted for estimated salvage value if there is sufficient degree of certainty of its realisation.

Actuarial Valuation of claim liability – in some cases

Claims made in respect of contracts where the claims payment period exceeds four years shall be recognised on an actuarial basis, subject to regulations that may be prescribed by the Authority. In such cases, certificate from a recognised actuary as to the fairness of liability assessment must be obtained. Actuarial assumptions shall be suitably disclosed by way of notes to the account.

6. Procedure to determine the value of investments.---An insurer shall determine the values of investments in the following manner:-

(a) Real Estate – Investment Property-- Investment Property shall be measured at historical cost less accumulated depreciation and impairment loss, residual value being considered zero and no revaluation being permissible.

The Insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

An impairment loss shall be recognised as an expense in the Revenue/Profit and Loss Account immediately.

Fair value as at the balance sheet date and the basis of its determination shall be disclosed in the financial statements as additional information.

(b) Debt Securities--Debt securities including government securities and redeemable preference shares shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) Equity Securities and Derivative Instruments that are traded in active markets--- Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price of the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies)/ derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogenous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealised gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading Fair Value Change Account in respect of a particular security and being recycled to Profit and Loss Account on actual sale of that listed security.

For the removal of doubt, it is clarified that balance or any part thereof shall not be available for distribution as dividends. Also, any debit balance in the said Fair Value Change Account shall be reduced from the profits/free reserves while declaring dividends.

The insurer shall assess, at each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognised as an expense in Revenue/Profit and Loss Account to the extent of the difference between the remeasured fair value of the security/ investment and its acquisition cost as reduced by any previous impairment loss recognised as expense in Revenue/Profit and Loss Account. Any reversal of impairment loss, earlier recognised in Revenue/Profit and Loss Account shall be recognised in Revenue/Profit and Loss Account.

(d) Unlisted and other than actively traded Equity Securities and Derivative Instruments--Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active market will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as "thinly traded".

7. Loans--Loans shall be measured at historical cost subject to impairment provisions.

The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India, that apply to companies and financial institutions.

8. Catastrophe Reserve -- Catastrophe reserve shall be created in accordance with norms, if any, prescribed by the Authority. Investment of funds out of catastrophe reserve shall be made in accordance with prescription of the Authority.

PART II

Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:
   - (a) Partly-paid up investments
   - (b) Underwriting commitments outstanding
   - (c) Claims, other than those under policies, not acknowledged as debts
   - (d) Guarantees given by or on behalf of the company
   - (e) Statutory demands/liabilities in dispute, not provided for
   - (f) Reinsurance obligations to the extent not provided for in accounts
   - (g) Others (to be specified)
2. Encumbrances to assets of the company in and outside India.
3. Commitments made and outstanding for Loans, Investments and Fixed Assets.
4. Claims, less reinsurance, paid to claimants in/outside India.
5. Actuarial assumptions for determination of claim liabilities in the case of claims where the claims payment period exceed four years.
6. Ageing of claims – distinguishing between claims outstanding for more than six months and other claims.
7. Premiums, less reinsurance, written from business in/outside India.
8. Extent of premium income recognised, based on varying risk pattern, category wise, with basis and justification therefor, including whether reliance has been placed on external evidence.
9. Value of contracts in relation to investments, for:
   - (a) Purchases where deliveries are pending;
   - (b) Sales where payments are overdue.

10. Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.
11. Historical costs of those investments valued on fair value basis.
12. Computation of managerial remuneration.
13. Basis of amortisation of debt securities.

14. (a) Unrealised gain/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'Fair Value Change Account' and on realisation reported in profit and loss Account.

    (b) Pending realisation, the credit balance in the 'Fair Value Change Account' is not available for distribution.

15. Fair value of investment property and the basis therefor.

16. Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer shall be stated in the manner required under Accounting Standard AS 1 issued by the ICAI.
2. Any departure from the accounting policies as aforesaid shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India.
2. Segregation into performing/ non performing investments for purpose of income recognition as per the directions, if any, issued by the Authority.
3. Percentage of business sector-wise.
4. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority.
5. Accounting Ratios as may be prescribed by the Authority.

6. Basis of allocation of Interest, Dividends and Rent between Revenue Account and Profit and Loss Account.

PART III

GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENTS

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account and Profit and Loss Account should be given.

2. The figures in the financial statements may be rounded off to the nearest thousands.

3. Interest, dividends and rentals receivable in connection with an investment should be stated as gross value, the amount of income tax deducted at source being included under 'advance taxes paid'.

4. Income from rent shall not include any notional rent.

5. (I) For the purposes of financial statements, unless the context otherwise requires -

   (a) the expression 'provision' shall, subject to note II below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

   (b) the expression "reserve" shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

   (c) the expression capital reserve shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

   (d) The expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

   (II) Where:

   (a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

   (b) any amount retained by way of providing for any known liability is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of these accounts as a reserve and not as a provision.

1. The company should make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.
2. Extent of risk retained and reinsured shall be separately disclosed.
3. Any debit balance of Profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance if any, shall be shown separately.

PART IV

CONTENTS OF MANAGEMENT REPORT

There shall be attached to the financial statements, a management report containing, *inter alia*, the following duly authenticated by the management:

1. Confirmation regarding the continued validity of the registration granted by the Authority;
2. Certification that all the dues payable to the statutory authorities have been duly paid;
3. Confirmation to the effect that the shareholding pattern and any transfer of shares during the year are in accordance with the statutory or regulatory requirements;
4. Declaration that the management has not directly or indirectly invested outside India the funds of the holders of policies issued in India;
5. Confirmation that the required solvency margins have been maintained;
6. Certification to the effect that the values of all the assets have been reviewed on the date of the Balance Sheet and that in his (insurer's) belief the assets set forth in the Balance-sheets are shown in the aggregate at amounts not exceeding their realisable or market value under the several headings – " Loans", " Investments", "Agents balances", "Outstanding Premiums", "Interest, Dividends and Rents outstanding", "Interest, Dividends and Rents accruing but not due", "Amounts due from other persons or Bodies carrying on insurance business", " Sundry Debtors", " Bills Receivable", " Cash" and the several items specified under "Other Accounts";
7. Disclosure with regard to the overall risk exposure and strategy adopted to mitigate the same;
8. Operations in other countries, if any, with a separate statement giving the management's estimate of country risk and exposure risk and the hedging strategy adopted;

9. Ageing of claims indicating the trends in average claim settlement time during the preceding five years;
10. Certification to the effect as to how the values, as shown in the balance sheet, of the investments and stocks and shares have been arrived at, and how the market value thereof has been ascertained for the purpose of comparison with the values so shown;
11. Review of asset quality and performance of investment in terms of portfolios, i.e., separately in terms of real estate, loans, investments, etc.
12. A responsibility statement indicating therein that:
    (i) in the preparation of financial statements, the applicable accounting standards, principles and policies have been followed along with proper explanations relating to material departures, if any;
    (ii) the management has adopted accounting policies and applied them consistently and made judgements and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the operating profit or loss and of the profit or loss of the company for the year;
    (iii) the management has taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the applicable provisions of the Insurance Act 1938 (4 of 1938) / Companies Act, 1956 (1 of 1956), for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities;
    (iv) the management has prepared the financial statements on a going concern basis;
    (v) the management has ensured that an internal audit system commensurate with the size and nature of the business exists and is operating effectively.
13. A schedule of payments, which have been made to individuals, firms, companies and organisations in which Directors of the insurer are interested.

PART V

Preparation of Financial Statements

(1) An insurer shall prepare the Revenue Account, Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form B-RA, Form B-PL, and Form B-BS, or as near thereto as the circumstances permit.

Provided that an insurer shall prepare Revenue Accounts separately for fire, marine, and miscellaneous insurance business and separate schedules shall be prepared for Marine Cargo, Marine – Other than Marine Cargo and the following classes of miscellaneous insurance business under miscellaneous insurance and accordingly application of AS 17 – Segment Reporting - shall stand modified.

1. Motor
2. Workmen's Compensation/Employers' Liability
3. Public/Product Liability
4. Engineering
5. Aviation
6. Personal Accident
7. Health Insurance
8. Others

(2) An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3 – "Cash Flow Statement" issued by the ICAI.

FORM B-RA

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

	Particulars	Schedule	Current Year	Previous Year
			(Rs.'000)	(Rs.'000)
1.	Premiums earned (Net)	1		
2.	Profit/ Loss on sale/redemption of Investments			
3.	Others (to be specified)			
4.	Interest, Dividend & Rent – Gross			
	TOTAL (A)			
1.	Claims Incurred (Net)	2		
2.	Commission	3		

3.	Operating Expenses related to Insurance Business	4		
	TOTAL (B)			
	Operating Profit/(Loss) from Fire/Marine/Miscellaneous Business C= (A - B)			
	APPROPRIATIONS			
	Transfer to Shareholders' Account			
	Transfer to Catastrophe Reserve			
	Transfer to Other Reserves (to be specified)			
	TOTAL (C)			

FORM B-PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

	Particulars	Schedule	Current Year	Previous Year
			(Rs.'000)	*(Rs.'000)*
1.	OPERATING PROFIT/(LOSS)			
	(a) Fire Insurance (b) Marine Insurance (c) Miscellaneous Insurance			
2.	INCOME FROM INVESTMENTS			
	(a) Interest, Dividend & Rent – Gross (b) Profit on sale of investments Less: Loss on sale of investments			
3.	OTHER INCOME (To be specified)			
	TOTAL (A)			

4.	PROVISIONS (Other than taxation)			
	(a) For diminution in the value of investments (b) For doubtful debts (c) Others (to be specified)			
5.	OTHER EXPENSES			
	(a) Expenses other than those related to Insurance Business (b) Bad debts written off (c) Others (To be specified)			
	TOTAL (B)			
	Profit Before Tax			
	Provision for Taxation			
	APPROPRIATIONS			
	(a) Interim dividends paid during the year (b) Proposed final dividend (c) Dividend distribution tax (d) Transfer to any Reserves or Other Accounts (to be specified)			
	Balance of profit/ loss brought forward from last year			
	Balance carried forward to Balance Sheet			

Notes: *to Form B-RA and B- PL*

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance premiums.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end,.

(d) *Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs.5,00,000 whichever is higher, shall be shown as a separate line item.*

(e) *Fees and expenses connected with claims shall be included in claims.*

(f) *Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.*

(g) *Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source"..*

(h) *Income from rent shall include only the realised rent. It shall not include any notional rent.*

FORM B-BS

Name of the Insurer:
Registration No. and Date of Registration with the IRDA

BALANCE SHEET AS AT 31ST MARCH, 20___.

		Schedule	Current Year	Previous Year
			(Rs.'000)	*(Rs.'000)*
	SOURCES OF FUNDS			
	SHARE CAPITAL	**5**		
	RESERVES AND SURPLUS	**6**		
	FAIR VALUE CHANGE ACCOUNT			
	BORROWINGS	**7**		
	TOTAL			
	APPLICATION OF FUNDS			
	INVESTMENTS	**8**		
	LOANS	**9**		
	FIXED ASSETS	**10**		
	CURRENT ASSETS			

	Cash and Bank Balances	**11**		
	Advances and Other Assets	**12**		
	Sub-Total (A)			
	CURRENT LIABILITIES	**13**		
	PROVISIONS	**14**		
	Sub-Total (B)			
	NET CURRENT ASSETS (C) = (A - B)			
	MISCELLANEOUS EXPENDITURE (to the extent not written off or adjusted)	**15**		
	DEBIT BALANCE IN PROFIT AND LOSS ACCOUNT			
	TOTAL			

CONTINGENT LIABILITIES

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Partly paid-up investments		
2.	Claims, other than against policies, not acknowledged as debts by the company		
3.	Underwriting commitments outstanding (in respect of shares and securities)		
4.	Guarantees given by or on behalf of the Company		
5.	Statutory demands/ liabilities in dispute, not provided for		
6.	Reinsurance obligations to the extent not provided for in accounts		
7.	Others (to be specified)		
	TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE – 1

PREMIUM EARNED [NET]

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
	Premium from direct business written Add: Premium on reinsurance accepted Less : Premium on reinsurance ceded Net Premium Adjustment for change in reserve for unexpired risks		
	Total Premium Earned (Net)		

Note: Reinsurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of reinsurance premiums.

SCHEDULE – 2

CLAIMS INCURRED [NET]

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
	Claims paid		
	Direct Add :Re-insurance accepted Less :Re-insurance Ceded Net Claims paid		
	Add Claims Outstanding at the end of the year		
	Less Claims Outstanding at the beginning		
	Total Claims Incurred		

Notes:

(a) *Incurred But Not Reported (IBNR), Incurred but not enough reported [IBNER] claims should be included in the amount for outstanding claims.*

(b) *Claims includes specific claims settlement cost but not expenses of management*

(c) *The surveyor fees, legal and other expenses shall also form part of claims cost.*

(d) *Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realisation.*

SCHEDULE- 3

COMMISSION

Particulars	Current Year	Previous Year
	(Rs.'000)	*(Rs.'000)*
Commission paid		
Direct *Add:* Re-insurance Accepted *Less:* Commission on Re-insurance Ceded		
Net Commission		

Note: The profit/ commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE – 4

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
1.	Employees' remuneration & welfare benefits		
2.	Travel, conveyance and vehicle running expenses		
3.	Training expenses		
4.	Rents, rates & taxes		
5.	Repairs		

6.	Printing & stationery		
7.	Communication		
8.	Legal & professional charges		
9.	Auditors' fees, expenses etc		
	(a) as auditor (b) as adviser or in any other capacity, in respect of (i) Taxation matters (ii) Insurance matters (iii) Management services; and (c) in any other capacity		
10.	Advertisement and publicity		
11.	Interest & Bank Charges		
12.	Others (to be specified)		
13.	Depreciation		
	TOTAL		

Note: Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs.5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE – 5

SHARE CAPITAL

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Authorised Capital		
	Equity Shares of Rs..... each		
2.	Issued Capital		
	Equity Shares of Rs. .....each		
3.	Subscribed Capital		

	Equity Shares of Rs.......each		
4.	Called-up Capital		
	Equity Shares of Rs. .....each		
	Less : Calls unpaid		
	Add : Equity Shares forfeited (Amount originally paid up) Less : Par Value of Equity Shares bought back		
	Less : Preliminary Expenses Expenses including commission or brokerage on Underwriting or subscription of shares		
	TOTAL		

Notes:

(a) Particulars of the different classes of capital should be separately stated.

(b) The amount capitalised on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE – 5A

SHARE CAPITAL

PATTERN OF SHAREHOLDING

[As certified by the Management]

Shareholder	**Current Year**	**Previous Year**		
	Number of Shares	**% of Holding**	**Number of Shares**	**% of Holding**
Promoters Indian Foreign				
Others				
TOTAL				

SCHEDULE – 6

RESERVES AND SURPLUS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	*(Rs.'000)*
1.	Capital Reserve		
2.	Capital Redemption Reserve		
3	Share Premium		
4	General Reserves Less: Debit balance in Profit and Loss Account Less: Amount utilized for Buy-back		
5	Catastrophe Reserve		
6	Other Reserves (to be specified)		
7	Balance of Profit in Profit & Loss Account		
	TOTAL		

Note: *Additions to and deductions from the reserves should be disclosed under each of the specified heads.*

SCHEDULE - 7

BORROWINGS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000).	*(Rs.'000).*
1.	Debentures/ Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to be specified)		
	TOTAL		

Notes:

(a) *The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.*

(b) *Amounts due within 12 months from the date of Balance Sheet should be shown separately*

SCHEDULE –8

INVESTMENTS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	*(Rs.'000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		

	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (a) Derivative Instruments (b) Debentures/ Bonds (c) Other Securities (to be specified) (d) Subsidiaries (e) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Notes:

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) Holding company and subsidiary shall be construed as defined in the Companies Act, 1956:

(ii) Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) Joint control - is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) Associate - is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) Significant influence (for the purpose of this schedule) - means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policymaking process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 percent or more of the voting power of

the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 percent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) *Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.*

(c) *Investments* made out of Catastrophe reserve should be shown separately.

(d) *Debt securities will be considered as "held to maturity" securities and will be measured at historical cost subject to amortisation.*

(e) *Investment Property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.*

(f) *Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall be classified as short-term investments*

SCHEDULE - 9

LOANS

	Particulars	**Current Year**	**Previous Year**
		(Rs.'000)	(Rs.'000)
1.	SECURITY-WISE CLASSIFICATION		
	Secured		
	(a) On mortgage of property (aa) In India (bb) Outside India		
	(b) On Shares, Bonds, Govt. Securities		
	(c) Others (to be specified)		
	Unsecured		
	TOTAL		

2.	BORROWER-WISE CLASSIFICATION		
	(a) Central and State Governments		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Industrial Undertakings		
	(e) Others (to be specified)		
	TOTAL		
3.	PERFORMANCE-WISE CLASSIFICATION		
	(a) Loans classified as standard (aa) In India (bb) Outside India (b) Non-performing loans less provisions (aa) In India (bb) Outside India		
	TOTAL		
4.	MATURITY-WISE CLASSIFICATION		
	(a) Short Term		
	(b) Long Term		
	TOTAL		

Notes:

(a) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

SCHEDULE – 10

FIXED ASSETS

(Rs.'000)

Particulars	Cost/ Gross Block				Depreciation				Net Block	
	Opening	Additions	Deductions	Closing	Upto Last Year	For The Year	On Sales/ Adjustments	To Date	As at year end	Previous Year
Goodwill										
Intangibles (specify)										
Land-Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work in progress										
Grand Total										
PREVIOUS YEAR										

Note: *Assets included in land, building and property above exclude Investment Properties as defined in note (e) to Schedule 8.*

SCHEDULE- 11

CASH AND BANK BALANCES

	Particulars	Current Year	Previous Year
		(Rs.'000)	(Rs.'000)
1.	Cash (including cheques, drafts and stamps)		
2.	Bank Balances		
	(a) Deposit Accounts (aa) Short-term (due within 12 months) (bb) Others (b) Current Accounts (c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks (b) With other Institutions		
4.	Others (to be specified)		
	TOTAL		
	Balances with non-scheduled banks included in 2 and 3 above		

Note : *Bank balance may include remittances in transit. If so, the nature and amount should be separately stated.*

SCHEDULE – 12

ADVANCES AND OTHER ASSETS

	Particulars	Current Year	Previous Year
		(Rs.'000)	(Rs.'000)
	ADVANCES		
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		

5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	TOTAL (A)		
	OTHER ASSETS		
1.	Income accrued on investments		
2.	Outstanding Premiums		
3.	Agents' Balances		
4.	Foreign Agencies Balances		
5.	Due from other entities carrying on insurance business (including reinsurers)		
6.	Due from subsidiaries/ holding		
7.	Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938]		
8.	Others (to be specified)		
	TOTAL (B)		
	TOTAL (A+B)		

Notes:

(a) *The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.*

(b) *The term 'officer' should conform to the definition of that term as given under the Companies Act, 1956.*

(c) *Sundry Debtors will be shown under item 9(others)*

SCHEDULE – 13

CURRENT LIABILITIES

	Particulars	Current Year	Previous Year
		(Rs.'000)	*(Rs.'000)*
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated Premium		
6.	Sundry creditors		
7.	Due to subsidiaries/ holding company		
8.	Claims Outstanding		
9.	Due to Officers/ Directors		
10.	Others (to be specified)		
	TOTAL		

SCHEDULE – 14

PROVISIONS

	Particulars	Current Year	Previous Year
		(Rs.'000)	(Rs.'000)
1	Reserve for Unexpired Risk		
2	For taxation (less advance tax paid and taxes deducted at source)		
3	For proposed dividends		
4	For dividend distribution tax		
5	Others (to be specified)		
	TOTAL		

SCHEDULE – 15

MISCELLANEOUS EXPENDITURE

(To the extent not written off or adjusted)

	Particulars	Current Year	Previous Year
		(Rs.'000)	(Rs.'000)
1.	Discount Allowed in issue of shares/ debentures		
2.	Others (to be specified)		
	TOTAL		

Notes:

(a) *No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:*

1. *some benefit from the expenditure can reasonably be expected to be received in future, and*

2. *the amount* of such benefit is reasonably determinable.

(b) *The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.*

SCHEDULE C

(See Regulation 3)

AUDITOR'S REPORT

The report of the auditors on the financial statements of every insurer shall deal with the matters specified herein:

1. (a) That they have obtained all the information and explanations which, to the best of their knowledge and belief were necessary for the purposes of their audit and whether they have found them satisfactory;

   (b) Whether proper books of account have been maintained by the insurer so far as appears from an examination of those books;

   (c) Whether proper returns, audited or unaudited, from branches and other offices have been received and whether they were adequate for the purpose of audit;

(d) Whether the Balance sheet, Revenue account , Profit and Loss account and the Receipts and Payments Account dealt with by the report are in agreement with the books of account and returns;

(e) Whether the actuarial valuation of liabilities is duly certified by the appointed actuary including to the effect that the assumptions for such valuation are in accordance with the guidelines and norms, if any, issued by the Authority, and/or the Actuarial Society of India in concurrence with the Authority.

2. The auditors shall express their opinion on:

(a) (i) Whether the balance sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;

(ii) Whether the revenue account gives a true and fair view of the surplus or the deficit for the financial year/period;

(iii) Whether the profit and loss account gives a true and fair view of the profit or loss for the financial year/period;

(iv) Whether the receipts and payments account gives a true and fair view of the receipts and payments for the financial year/period;

(b) The financial statements stated at (a) above are prepared in accordance with the requirements of the Insurance Act, 1938 (4 of 1938), the Insurance Regulatory and Development Authority Act, 1999 (41 of 1999) and the Companies Act, 1956 (1 of 1956), to the extent applicable and in the manner so required.

(c) Investments have been valued in accordance with the provisions of the Act and these Regulations.

(d) The accounting policies selected by the insurer are appropriate and are in compliance with the applicable accounting standards and with the accounting principles, as prescribed in these Regulations or any order or direction issued by the Authority in this behalf.

3. The auditors shall further certify that:

(a) they have reviewed the management report and there is no apparent mistake or material inconsistencies with the financial statements;

(b) the insurer has complied with the terms and conditions of the registration stipulated by the Authority.

4. A certificate signed by the auditors [which shall be in addition to any other certificate or report which is required by law to be given with respect to the balance sheet] certifying that:–

(a) they have verified the cash balances and the securities relating to the insurer's loans, reversions and life interests (in the case of life insurers) and investments;

(b) to what extent, if any, they have verified the investments and transactions relating to any trusts undertaken by the insurer as trustee; and

(c) no part of the assets of the policyholders' funds has been directly or indirectly applied in contravention of the provisions of the Insurance Act, 1938 (4 of 1938) relating to the application and investments of the policyholders' funds.

[F.No.IRDA/Reg/03/2002]

3.5 PREPARATION OF FINANCIAL STATEMENTS

After studying IRDA Regulations, let us work out few illustrations which will help you in understanding the procedure for preparation of financial statements of insurance companies.

Illustration 1

From the following balance as at 31st March, 2008 in the books on the National Life Assurance Co. Ltd., prepare Profit and Loss Account and Balance Sheet.

	'000 Rs.		*'000 Rs.*
Life Assurance Fund on 1st		Agents' Balances	18,000
April, 2007	34,00,000	Advances to ceding companies	47,000
Annuities paid (in India 72,500)	81,750	Due from Re-insurers	38,500
		Due to Re-insurers	47,500
General Reserve	2,25,000	Sundry Creditors	1,800
Deposit with the Reserve Bank		Premiums : First year	5,90,000
—Government Securities	2,10,000	Renewal	1,20,000
Indian Government Securities	10,90,000	Reinsurance accepted	50,000
Foreign Government Securities	75,000	Reinsurance ceded	70,000
		Interim Bonus to Policy-holders	22,500
		Commission –	
		Direct : First year	40,500
		Renewal	2,000
		Reinsurance accepted	12,000
		Reinsurance ceded	4,000

		Claims	
Loan on Company's Policies	2,10,000	—By Death (in India 1,30,000)	2,00,000
Leasehold Buildings	63,300	—By Maturity (in India 1,40,000)	2,20,000
Securities on which interest is		Bank Loan	21,750
guaranteed by the Government	4,50,000	Salaries	30,400
Stocks of Shares of companies			
incorporated in India	14,50,000	Auditors' Fees	5,000
Share Capital (20,000 shares @	20,00,000		
Rs. 100 each)			
Mortgages in India	14,32,500	Law Charges	3,400
Cash with Bankers on		Rent paid	3,600
Current Account	40,500	Other Expenses of Management	750
Cash with Bankers on		Travelling Expenses	1,950
Deposit (short-term) Account	20,000	Interest and Rents	
Cash in hand	7,000	Received (Gross)	1,95,000
State Government Securities	7,25,000	Proposed divided @ 10%	
Furniture and Fixtures	39,000		
Outstanding Premiums	66,000		

Transfer the surplus amount if any to Life Fund for the year ended 31st March, 2008 5% Dividend is also proposed.

Solution :

IN THE BOOKS OF NATIONAL ASSURANCE CO. LTD.

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 2008

Policyholders' Account (Technical Account)

Particulars	**Schedule**	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
Premiums earned – net			
(a) Premium	1	7,10,000	
(b) Reinsurance ceded		(70,000)	

(c)	Reinsurance accepted		50,000
			6,90,000
Income from Investments			
(a)	Interest, Dividends & Rent – Gross		2,16,000
(b)	Profit on sale redemption of investments		
(c)	(Loss on sale/redemption of investments)		
(d)	Transfer/Gain on revaluation change in fair value*		
Other Income (to be specified)			
	Total (A)		9,06,000
Commission		2	50,500
Operating Expenses related to Insurance Business		3	45,500
Other Expenses (to be specified)			—
Provisions (other than taxation)			
(a)	For diminution in the value of investments (Net)		
(b)	Others (to be specified)		
	Total (B)		96,000
Benefits Paid (Net)		4	5,01,750
Interim Bonuses Paid			22,500
Change in valuation of liability against life policies in force			
(a)	Gross**		
(b)	(Amount ceded in Reinsurance)		
(c)	Amount accepted in Reinsurance		
	Total (C)		5,24,250
Surplus [(A) – (B) – (D)]			2,85,750
APPROPRIATIONS			
Transfer to Shareholders' Account			
Transfer to Other Reserves (to be specified)			
Transfer to Funds for Future Appropriations			1,85,750
	Total (D)		1,85,750

Form A-PL

PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 2006

Shareholders' Account (Non-technical Account)

Particulars	Schedule	Current Year *(Rs. '000)*	Previous Year *(Rs. '000)*
Balance brought forward from/transferred to the Policyholders Account (Technical Account)		2,85,750	
Income From Investments			
(a) Interest, Dividends & Rent – Gross			
(b) Profit on sale/redemption of investments			
(c) (Loss on sale/redemption on investments)			
Other Income (To be specified)			
Total (A)			
Expense other than those directly related to the insurance business			
Provisions (Other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Other (to be specified)			
Total (B)			
Profit/(Loss) before tax			
Provision for Taxation			
Profit/(Loss) after tax			
APPROPRIATIONS			
(a) Brought forward Reserve Surplus from the Balance Sheet			
(b) Interim dividends paid during the year			
(c) Proposed final dividend		1,00,000	
(d) Dividend distribution on tax			
(e) Transfer to reserves/other accounts (to be specified)		85,750	
Profit carried forward to the Balance Sheet		1,85,750	

Notes :

(a) In case of premiums, less reinsurance in respect of any segment of insurance business of total Premium earned, the same shall be disclosed separately.

(b) *Premium income received from business concluded in and outside India shall be separately disclosed.*

(c) *Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e., before deducting commissions) under the head reinsurance premiums.*

(d) *Claims incurred shall comprise claims paid, settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.*

(e) *Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or Rs. 5,00,000 whichever is higher, shall be shown as a separate line item.*

(f) *Fees and expenses connected with claims shall be included in claims.*

(g) *Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.*

(h) *Interest, dividends and rentals receivable in connection with the investment should be stated as gross amount, the amount of income tax deducted at source being included under advance taxes paid and taxes deducted at source."*

(i) *Income from rent shall include only the realised rent. It shall not include any notional rent.*

BALANCE SHEET AT 31ST MARCH, 2008

Shareholders' Account (Non-technical Account)

	Schedule	Current Year *(Rs. '000)*	Previous Year *(Rs. '000)*
SOURCES OF FUNDS			
Shareholders' Funds			
Share Capital	5	20,00,000	
Reserves and Surplus	6	38,10,750	
Credit/[Debit] Fair value change account			
Sub-Total			
Borrowings	7	69,250	
Policyholders' Funds			
Credit/[Debit] Fair value change account			

Policy Liabilities		
Insurance reserves		
Provision for linked liabilities		
Sub-Total		
Funds for future appropriations		
Total		58,80,000
APPLICATION OF FUNDS		
Investments	8	40,00,000
Shareholders'		
Policyholders'		
Assets held to cover linked liabilities		
Loans	9	16,42,500
Fixed Assets	10	1,02,300
Current Assets		
Cash and Bank Balances	11	67,500
Advances and Other Assets	12	1,69,500
Sub-Total (A)		2,37,000
Current Liabilities	13	1,800
Provisions	14	1,00,000
Sub-Total (B)		1,01,800
Net Current Assets (C) = (A – B)		1,35,200
Miscellaneous expenditure		—
(to the extent not written off or adjusted)		
Debit Balance in profit & Loss Account		
(Shareholders' Account)		
Total [Sch.8,9,10 & (C)]		58,80,000

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE–1
PREMIUM

	Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
1.	First year premiums	5,90,000	
2.	Renewal premiums	1,20,000	
3.	Single premiums		
	Total premiums	7,10,000	

	Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
	Premiums Income from business written :		
1.	In India		
2.	Outside India		
	Total premiums (Net)		

Notes :

Reinsurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of reinsurance premiums.

SCHEDULE–2
COMMISSION EXPENSES

Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
Commission paid		
Direct – First year premium	40,500	
– Renewal premiums	2,000	
– Single premiums		
Add : Commission on Re-insurance Accepted	12,000	
Less : Commission on Re-insurance Ceded	(4,000)	
Net Commission	50,500	

Notes :

The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE–3

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
1. Employees' remuneration & welfare benefits	30,400	
2. Travel, conveyance and vehicle running expenses	1,950	
3. Rents, rates & taxes	3,600	
4. Repairs		
5. Printing & stationery		
6. Communication expenses		
7. Legal & professional charges	3,400	
8. Medical fees		
9. Auditors' fees, expenses etc.	5,400	
(a) as auditor		
(b) as adviser or in any other capacity, in respect of		
(i) Taxation matters		
(ii) Insurance matters		
(iii) Managements services, and		
(c) in any other capacity		
10. Advertisement and publicity		
11. Interest & Bank Charges		
12. Others (to be specified)	750	
13. Depreciation		
Total	45,500	

Notes :

(a) *Items of expenses in excess of one percent of the net premium or Rs. 5,00,000 whichever is higher, shall be shown as a separate line item.*

(b) Under the sub-head "Others", 'Operating Expenses (Insurance Business)' Shall include items like foreign exchange gains or losses and other items.

SCHEDULE–4
BENEFITS PAID [NET]

	Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
1.	Insurance Claims		
	(a) Claims by Death,	2,00,000	
	(b) Claims by Maturity,	2,20,000	
	(c) Annuities/Pensions in payment,	81,750	
	(d) Other benefits, specify		
2.	(Amount ceded in reinsurance) :		
	(a) Claims by Death,		
	(b) Claims by Maturity,		
	(c) Annuities/Pensions in payment,		
	(d) Other benefits, specify		
3.	Amount accepted in reinsurance :		
	(a) Claims by Death,		
	(b) Claims by Maturity,		
	(c) Annuities/Pensions in payment,		
	(d) Other benefits, specify		
	Total	5,01,750	
	Benefits paid to claimants :		
1.	In India	3,42,500	
2.	Outside India	1,59,250	
	Total Benefits paid (Net)	5,01,750	

Notes :

(a) Claims include claims settlement costs, wherever applicable.

(b) The legal and other fees and expenses shall also form part of the claims cost, wherever applicable

SCHEDULE–5
SHARE CAPITAL

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Authorised Capital		
Equity Shares of Rs. ...... each		
2. Issued Capital		
Equity Shares of Rs. ...... each		
3. Subscribed Capital		
Equity Shares of Rs. ...... each	20,00,000	
4. Called-up Capital		
Equity Shares of Rs. ...... each		
5. *Less :* Calls unpaid		
Add : Share forfeited (Amount Originally paid up)		
Less : Par value of Equity Shares bought back		
Less : Preliminary Expenses		
Expenses including commission or brokerage on Underwriting or subscription of shares		
Total	20,00,000	

Notes :

(a) Particulars of the different classes of capital should be separated stated.

(b) The amount capitalised on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE–5A
PATTERN OF SHAREHOLDING
[As certified by the Management]

Particulars	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Promoters				
• Indian				
• Foreign				
Others				
Total				

SCHEDULE–6
RESERVES AND SURPLUS

Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
1. Capital Reserve		
2. Capital Redemption Reserve		
3. Share Premium		
4. Revaluation Reserve		
5. General Reserves	2,25,000	2,25,000
Less : Debit balance in Profit and Loss Account, if any		
Less Amount utilized for Buy-back		
6. Catastrophe Reserve		
7. Other Reserves (to be specified) Life Fund	35,85,750	34,00,000
8. Balance of profit in Profit and Loss Account		
Total	**38,10,750**	**36,25,000**

Notes :

Additions to and deductions from the reserves should be disclosed under each of the specified heads.

SCHEDULE–7
BORROWINGS

Particulars	Current Year *(Rs. '000)*	Previous Year *(Rs. '000)*
1. Debentures/Bonds		
2. Fixed Deposits		
3. Banks	21,750	
4. Financial Institutions		
5. Other entities carrying on insurance business	47,500	
6. Others (to be specified)		
Total	71,050	

Notes :

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(b) Amounts due within 12 months from the date of Balance, Sheet should be shown separately.

The classification of investments as desired by schedule 8 and 8A of the format can't be done due to non-availability, of formation of shareholders' and policyholders' investments. Therefore, investments are shown as follows (included as total figure in the Balance Sheet)

SCHEDULE–7
INVESTMENTS :

Particulars	Current Year *(Rs. '000)*	Previous Year *(Rs. '000)*
Deposit with the RBI	2,10,000	
Indian Government Securities	10,90,000	
State Government Securities	7,25,000	
Foreign Government Securities	75,000	

Securities guaranteed by the Government	4,50,000
Stock and shares of companies incorporated in India	14,50,000
	40,00,000

SCHEDULE–9
LOANS

Particulars	Current Year *(Rs. '000)*	Previous Year *(Rs. '000)*
1. Security-wise classification		
Secured		
(a) On mortgage of property		
(aa) In India	14,32,500	
(bb) Outside India		
(b) On shares, Bonds, Govt. Securities, etc.		
(b) Others (to be specified)		
Unsecured		
(a) Loans against policies	2,10,000	
(b) Others (to be specified)		
Total	16,42,500	
2. Borrower-wise classification		
(a) Central and State Governments		
(b) Banks and Financial Institutions		
(c) Subsidiaries		
(d) Companies		
(e) Loans against policies		
(f) Others (to be specified)		
Total		
3. Performance-wise classification		
(a) Loans classified as standard		
(aa) In India		

(bb) Outside India

(b) Non-standard loans less provisions

(aa) In India

(bb) Outside India

Total

4. Maturity-wise classification

(a) Short Term

(b) Long Term

Total

Notes :

(a) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of his schedule, means loans secured wholly or partly against on asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

SCHEDULE–10

FIXED ASSETS

(Rs. '000)

Particulars	**Cost/Gross Block**	**Depreciation**	**Net Block**
Goodwill			
Intangibles (specify)			
Land-Freehold			
Leasehold Property			63,300
Buildings			
Furniture & Fittings			39,000

Information Technology	
Equipment	
Vehicles	
Office Equipment	
Others (Specify nature)	
Total	1,02,300

Notes :

Assets included in land, property and building above exclude Investment Properties as defined in note (e) to Schedule 8.

SCHEDULE–11

CASH AND BANK BALANCES

	Particulars	**Current Year** *(Rs. '000)*	**Previous Year** *(Rs. '000)*
1.	Cash (including cheques, drafts and stamps)	7,000	
2.	Bank Balances		
	(a) Deposit Accounts		
	(aa) Short-term (due within 12 months of the date of Balance Sheet)	20,000	
	(bb) Others		
	(b) Current Accounts	40,500	
	(c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		
	(b) With other Institutions		
4.	Others (to be specified)		
	Total	67,500	
	Balances with non-scheduled banks included in 2 and 3 above		

Illustration 2

The following are the Balances of Hercules Insurance Co. Ltd. as on 31st March, 2008 :

		(Rs. in '000)
Capital		320,00
Balances of Funds as on 1.4.07		
Fire Insurance		800,00
Marine Insurance		950,00
Miscellaneous Insurance		218,65
Unclaimed Dividends		8,50
Amount Due to Other Insurance Companies		34,50
Sundry Creditors		72,50
Deposit and Suspense Account (Cr.)		22,80
Profit and Loss Account (Cr.)		80,40
Agents Balances (Dr.)		135,00
Interest accrued but not due (Dr.)		22,50
Due from other Insurance Companies		64,50
Cash in Hand		3,50
Balance in Current Account with Bank		74,80
Furniture and Fixtures WDV (cost 100,00)		58,00
Stationery Stock		1,40
Expenses of Management		
Fire Insurance	280,00	
Marine Insurance	160,00	
Miscellaneous Insurance	40,00	
Others	30,00	510,00
Foreign Taxes—Marine		8,00
Outstanding premium		82,00

Donation Paid (No 80G Benefit)		10,00
Transfer Fees		1,00
Reserve for Bad Debts		11,70
Income Tax Paid		120,00
Mortgage Loan (Dr.)		975,00
Sundry Debtors		25,00
Government Securities Deposited with RBI		37,00
Government Securities (1020,00)		1020,00
Debentures		465,50
Equity Shares of Joint Stock Companies		225,00
Claims Less Re-insurance		
Fire	450,00	
Marine	358,90	
Miscellaneous	68,00	876,90
Premium Less Re-insurance		
Fire	1762,50	
Marine	1022,50	
Miscellaneous	262,25	3047,25
Interest and Dividends Received on Investments		58,50
Tax Deducted at Source		11,70
Commission		
Fire	500,00	
Marine	350,00	
Miscellaneous	80,00	930,00

You are required to make the following provisions :

Depreciation on Furniture—10% of Original Cost	
Depreciation on investments of Joint Stock Companies Shares	10,00
Transfer to General Reserve	10,00

Outstanding claims as on 31.3.08

Fire	200,00
Marine	50,00
Miscellaneous	32,50

Provision for tax @50%. Proposed dividends @20%. Provision for the unexpired risks is to be made as follows:

(a) On Marine Policies 100% Premium less reinsurance.

(b) On Other Policies 50% Premium less reinsurance.

You are required to prepare the revenue and profit and loss account for the year ended 31.3.2006 of the company.

Solution

Form B – RA (Prescribed by IRDA)
Hercules Insurance Co. Ltd.

Revenue Account for the year ended 31st March, 2008

Fire and Marine and Misc Insurance Businesses

	Schedule	Fire Current Year	Marine Current Year	Misc. Current Year
		Rs. '000	*Rs. '000*	*Rs. '000*
Premiums earned (net)	1	1681,25	950,00	349,77
Interest, Dividends and Rent – Gross		—	—	—
Double Income Tax refund		—	—	—
Profit on sale of motor car		—	—	—
Total (A)		1681,25	950,00	349,77
Claims incurred (net)	2	650,00	408,90	100,50
Commission	3	500,00	350,00	80,00
Operating expenses related to Insurance business	4	280,00	160,00	40,00

Bad debts	—	—	—
Indian and Foreign taxes	—	8,00	—
Total (B)	1430,00	926,90	220,50
Profit from Marine Insurance business (A B)	251,25	23,10	129,27

Schedules forming part of Revenue Account

Schedule –1

Premiums earned (net)	**Fire Current Year**	**Marine Current Year**	**Misc. Current Year**
	Rs. '000	*Rs*'000.	*Rs.* '000
Premiums *Less* reinsurance (net)	1762,50	1022,50	262,25
Change in provision for unexpired risk	(-)81,25	(-) 72,50	87,52
Premiums earned (net)	1681, 25	950,00	349,77
Schedule – 2			
Claims incurred (net)	650,00	408,90	100,50
Schedule – 3			
Commission paid	500,00	350,00	80,00
Schedule – 4			
Operating expenses related to insurance business			
Expenses of Management	280,00	160,00	40,00

Form B-PL

Hercules Insurance Co. Ltd.

Profit and Loss Account for the year 31st March, 2008

Particulars	**Sche dule**	**Current Year**	**Previous Year**
		Rs. ' (000)	*Rs. ' (000)*
Operating Profit/(Loss)			

(a) Fire Insurance	251,25
(b) Marine Insurance	23,10
(c) Miscellaneous	129,27
Income From Investments	
(a) Interest, Dividend & Rent–Gross	58,50
Other Income	
Transfer Fees	1,00
Total (A)	463,12
Provisions (Other than taxation)	
Depreciation of Furniture	10,00
Depreciation of Investments	10,00
Other Expenses –	
Expenses of Management	30,00
Donation	10,00
Total (B)	60,00
Profit Before Tax	403,12
Provision for Taxation	206,56
Profit After Tax	196,56
Profit	
(a) Interim dividends paid during the year	—
(b) Proposed final dividend	64,00
(c) Dividend distribution tax	—
(d) Transfer to General Reserves or Other Accounts (to be specified)	10,00
Balance of profit/loss brought forward from last year	80,40
Balance carried forward to Balance Sheet	202,96

Working Notes :

1. Reserve for unexpired risk 50% of net premium for fire and miscellaneous and 100% of net premium for marine.

2. Provision for Taxation *Rs.*

Net Profit before tax	403,12
Add : Donation	10,00
Taxable Profit	413,12
Tax 50%	

Illustration 3

From the following figures appearing in the books of Fire Insurance division of a General Insurance Company, show the amount of claim as it would appear in the Revenue Account for the year ended 31st March, 2008 :

		Direct Business	Re-Insurance
		Rs.	Rs.
Claim paid during the year		46,70,000	7,00,000
Claim Payable—	1st April, 2007	7,63,000	87,000
	31st March, 2008	8,12,000	53,000
Claims received		–	2,30,000
Claims Receivable—	1st April, 2007	–	65,000
	31st March, 2008	–	1,13,000
Expenses of Management		2,30,000	–
(includes Rs. 35,000 Surveyor's fee and Rs. 45,000 Legal expenses for settlement of claims)			

Solution

General Insurance Company

(Abstract showing the amount of claims)

	Rs. '000	*Rs. '000*
Claims *less* Re-insurance :		
Paid during the year	52,20	
Add : Outstanding claims at the end of the year	7,52	
	59,72	
Less : Outstanding claims at the beginning of the year	7,85	51,87

Working Notes :

		Rs. '000	Rs. '000
1.	Claims paid during the year		
	Direct business	46,70	
	Reinsurance	7,00	53,70
	Add : Surveyor's fee	35	
	Legal expenses	45	80
			54,50
	Less : Claims received from re-insurers		2,30
			52,20
2.	Claims outstanding on 31st March, 2008		
	Direct business	8,12	
	Reinsurance	53	8,65
	Less : Claims receivable from re-insurers		1,13
			7,52
3.	Claims outstanding on 1st April, 2007		
	Direct business	763	
	Reinsurance	87	8,50
	Less : Claims receivable from re-insurers		65
			7,85

Illustration 4

From the following balances extracted from the books of Perfect General Insurance Company Limited as on 31.3.2008 you are required to prepare Revenue Accounts in respect of Fire and marine Insurance business for the year ended 31.3.2006to and a Profit and Loss Account for the same period :

	Rs.		Rs.
Directors' Fees	80,000	Interest received	19,000
Dividend received	1,00,000	Fixed Assets (1.4.2007)	90,000
Provision for Taxation		Income-tax paid during	
(as on 1.4. 2007)	85,000	the year	60,000

	Fire	Marine
Outstanding Claims on 1.4.2007	28,000	7,000
Claims paid	1,00,000	80,000
Reserve for Unexpired Risk on 1.4.2007	2,00,000	1,40,000
Premiums Received	4,50,000	3,30,000
Agent's Commission	40,000	20,000
Expenses of Management	60,000	45,000
Re-insurance Premium (Dr.)	25,000	15,000

The following additional points are also to be taken into account :

(a) Depreciation on Fixed Assets to be provided at 10% p.a.

(b) Interest accrued on investments Rs. 10,000.

(c) Closing provision for taxation on 31.3.2008 be maintained at Rs. 1,24,138

(d) Claims outstanding on 31.3.2008 were Fire Insurance Rs. 10,000; Marine Insurance Rs. 15,000.

(e) Premium outstanding on 31.3.2008 were Fire Insurance Rs. 30,000; Marine Insurance Rs. 20,000.

(f) Reserve for unexpired risk to be maintained at 50% and 100% of net premiums in respect of Fire and Marine Insurance respectively.

(g) Expenses of management due on 31.3.2008 were Rs. 10,000 for Fire Insurance and Rs. 5,000 in respect of marine Insurance.

Solution

Form B – RA (Prescribed by IRDA)
Perfect General Insurance Co. Ltd

Revenue Account for the year ended 31st March, 2008

Fire and Marine Insurance Businesses

	Schedule	**Fire Current Year**	**Marine Current Year**
		Rs.	*Rs.*
Premiums earned (net)	1	4,55,000	3,35,000
Change in provision for unexpired risk		(-)27,500	(-) 1,95,000

Interest, Dividends and Rent – Gross		—	—
Double Income Tax refund		—	—
Profit on sale of motor car		—	—
Total (A)		4,27,500	1,40,000
Claims incurred (net)	2	82,000	88,000
Commission	3	40,000	20,000
Operating expenses related to Insurance business	4	70,000	50,000
Bad debts		—	—
Indian and Foreign taxes		—	—
Total (B)		1,92,000	1,58,000
Profit from Marine Insurance business (A-B)		2,35,500	(18000)

Schedules forming part of Revenue Account

Schedule –1

Premiums earned (net)	*Fire Current Year*	*Marine Current Year*
	Rs.	*Rs.*
Premiums from direct business written	4,80,000	3,50,000
Less: Premium on reinsurance ceded	25,000	15,000
Total Premium earned (net)	4,55,000	3,35,000

Schedule – 2

Claims incurred (net)	82,000	88,000

Schedule – 4

Operating expenses related to insurance business		
Expenses of Management	70,000	50,000

Form B-PL
Perfect General Insurance Co. Ltd.
Profit and Loss Account for the year 31st March, 2008

Particulars	**Schedule**	**Current Year**	**Previous Year**
		Rs.	*Rs.*
Operating Profit/(Loss)			
(a) Fire Insurance		2,35,500	
(b) Marine Insurance		(18,000)	
(c) Miscellaneous Insurance		—	
Income From Investments			
(b) Interest, Dividend & Rent–Gross		1,29,000	
(c) Profit on sale of investments			
Less : Loss on sale of investments			
Other Income (To be specified)			
Total (A)		3,46,500	
Provisions (Other than taxation)		—	
Depreciation		9,000	
Other Expenses –Director's Fee		80,000	
Total (B)		89,000	
Profit Before Tax		2,57,500	
Provision for Taxation		99,138	
Profit After Tax		1,58,362	

Working Notes :

		Fire	Marine
		Rs.	Rs.
1.	Claims under policies less reinsurance		
	Claims paid during the year	1,00,000	80,000
	Add: Outstanding on 31st March, 2008	10,000	15,000
		1,10,000	95,000
	Less : Outstanding on 1st April, 2007	28,000	7,000
		82,000	88,000
2.	Expenses of management		
	Expenses paid during the year	60,000	45,000
	Add: Outstanding on 31st March, 2008	10,000	5,000
		70,000	50,000
3.	Premiums less reinsurance		
	Premiums received during the year	4,50,000	3,30,000
	Add: Outstanding on 31st March, 2007	30,000	20,000
		4,80,000	3,50,000
	Less : Reinsurance premiums	25,000	15,000
		4,55,000	3,35,000

4. Reserve for unexpired risks is 50% of net premium for fire insurance and 100% of net premium for marine insurance.

5. **Provision for taxation account**

		Rs.			Rs.
31.3.2008	To Bank A/c		1.4.2007	By Balance b/d	85,000
	(taxes paid)	60,000	31.3.2008	By P & L A/c	99,138
31.3.2008	To Balance c/d	1,24,138			
		1,84,138			1,84,138

SELF EXAMINATION QUESTIONS

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. As per IRDA Regulations, 2002, Sun Light Insurance Company carrying business of more than one type of insurance business is required to prepare
   - (a) A separate revenue account for each type of business.
   - (b) A separate profit and loss account for each type of business.
   - (c) A separate balance sheet for each type of business.
   - (d) A separate revenue and profit and loss account for each type of business but a combined balance sheet.
2. In case of fire insurance, the provision required to make against unexpired risks is
   - (a) 40%.
   - (b) 50%.
   - (c) 100%.
   - (d) 30%
3. As per IRDA Regulations, an insurance company is required to prepare
   - (a) Revenue account.
   - (b) Profit and loss account.
   - (c) Balance sheet.
   - (d) All of the above.

[**Answer 1** (a); **2** (b); **3**(d)]

II. Short Answer Type Questions

4. Write a note on computation of 'premium income' and 'commission expense' in the case of an insurance company.
5. Explain the presentation in the financial statements of the following items:
   - (i) Claims paid on re-insurance business.
   - (ii) Commission on re-insurance business.

III. Long Answer Type Questions

6. What are the accounting entries pertaining to re-insurance business ceded to and by an insurance company? What are the corresponding commission entries?

IV. Practical Problems

7. From the following information as on 31st March, 2008, prepare the Revenue Accounts of Sagar Bhima Co. Ltd. engaged in Marine Insurance Business:

	Particulars	*Direct Business*	*Re-insurance*
		(Rs.)	*(Rs.)*
I.	Premium :		
	Received	24,00,000	3,60,000
	Receivable – 1st April, 2007	1,20,000	21,000
	– 31st March, 2008	1,80,000	28,000
	Premium paid	2,40,000	–
	Payable – 1st April, 2007	–	20,000
	– 31st March, 2008	–	42,000
II.	Claims :		
	Paid	16,50,000	1,25,000
	Payable – 1st April, 2007	95,000	13,000
	– 31st March, 2008	1,75,000	22,000
	Received	–	1,00,000
	Receivable – 1st April, 2007	–	9,000
	– 31st March, 2008	–	12,000
III.	Commission :		
	On Insurance accepted	1,50,000	11,000
	On Insurance ceded	–	14,000

Other expenses and income:

Salaries – Rs. 2,60,000; Rent, Rates and Taxes – Rs. 18,000; Printing and Stationery – Rs. 23,000; Indian Income Tax paid – Rs. 2,40,000; Interest, Dividend and Rent received (net) – Rs. 1,15,500; Income Tax deducted at source – Rs. 24,500; Legal Expenses (Inclusive of Rs. 20,000 in connection with the settlement of claims) – Rs. 60,000; Bad Debts – Rs. 5,000; Double Income Tax refund – Rs. 12,000; Profit on Sale of Motor car Rs. 5,000.

Balance of Fund on 1st April, 2007 was Rs. 26,50,000 including Additional Reserve of Rs. 3,25,000. Additional Reserve has to be maintained at 5% of the net premium of the year.

8. In 2008, the Delta Mutual Life Insurance Co. Ltd. paid the following amounts :

Against policies which matured	5,00,000
Against policies the holders of which died	1,00,000
Against policies which have been surrendered	20,000
Against policies which were declared paid-up sometimes ago	5,000
Interim Bonus on policies amounts of which have been paid	3,000
Bonus in cash	4,000

How much will be the amount to be shown in the Revenue Accounts as claim ?

9. The under mentioned figures amongst others appeared in the books of Y General Insurance Co. Ltd., as on 31st March, 2008.

	Rs.
Claims outstanding	30,000
Claims Paid	3,70,700
Claims covered under re-insurance	37,000
Commission on re-insurance premiums paid	5,000
Surveyors fees regarding claims	15,000

There were outstanding claims on 31st March, 2008 totaling Rs. 38,000. Which is the amount that will be debited to the Revenue Account in respect of claims?

10. X Fire Insurance Co. Ltd. commenced in 2008 for which year its books showed the following :

	Rs.
Premiums received	10,00,000
Re-insurance premiums paid	60,000
Claims paid	2,10,000
Expenses of Management	3,20,000
Commission paid	80,000
Claims unpaid at the end of year	40,000

Claims cover all policies. Prepare the Revenue Account assuming that the claims have been arisen over policies in general.

CHAPTER 6

FINANCIAL STATEMENTS OF BANKING COMPANIES

UNIT-1: SOME RELEVANT PROVISIONS OF THE BANKING REGULATIONS ACT, 1949

Learning Objectives

After studying this unit, you will be able to:

- Understand the legal definition of banking and the composition of management team of a bank.
- Learn the conditions to be fulfilled for obtaining a license for banking activities in India.
- Learn the provisions relating to capital, reserve, liquidity norm, reserve fund, dividend payment and disposal of non-banking assets.
- Try to relate such provisions with the financial information obtained from any banking companies.

Recommended Texts : Banking Regulations Act, 1949

Guidance Note on Audit of Banks, ICAI

1.1 MEANING OF BANKING

Bank is an important organ of the modern trade and commerce. Banks in India are regulated by the Banking Regulation Act, 1949. The banking activities in India are regulated by the Banking Regulations Act, 1949. Under Section 5(*b*) of the said Act "Banking" means, the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise. Any bank which transacts this business in India is called a banking company. However, any company which is engaged in the manufacturer of goods or carries on any trade and which accepts deposits of money from the public merely for the purpose of financing its business as manufacturer or trader shall not be deemed to transact the business of banking. It may be mentioned that the Banking Regulation Act, 1949 is not applicable to a primary agricultural society, a co-operative land mortgage bank and any other co-operative society except in the manner and to the extent specified in Part V of the Act.

Some banks are included in the Second Schedule to the Reserve Bank of India Act, 1934; these are called Scheduled Banks. The Reserve Bank includes a bank in this schedule if it fulfils certain conditions. The Reserve Bank gives certain facilities to scheduled banks including the following:

(a) The purchase, sale, and re-discounting of certain bills of exchange, or promissory notes;

(b) Purchase and sale of foreign exchange;

(c) Purchase, sale and re-discounting of foreign bills of exchange;

(d) Making of loans and advances to scheduled banks;

(e) Maintenance of accounts of the scheduled bank in its banking department and issue department;

(f) Remittance of money between different branches of scheduled banks through the offices, branches or agencies of Reserve Bank free of cost or at nominal rates.

Section 6 of the Banking Regulation Act, 1949 specifies the forms of business in which a banking company may engage. These are :

(i) borrowing, raising or taking up of money; lending or advancing of money; drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, hundies, promissory notes, etc.;

(ii) acting as agents for any government or local authority or any other person;

(iii) directing for public and private loans and negotiating and issuing the same;

(iv) effecting, insuring, guaranteeing, under-writing, participating in managing and carrying out of any issue of shares, stock, debentures etc.;

(v) carrying on and transacting every kind of guarantee and indemnity business;

(vi) managing, selling and realising property which may come into the possession of the banking company in satisfaction of its claim;

(vii) acquiring and holding and generally dealing with any property or any right, title or interest in such property which may form the security for any loans and advances;

(viii) underwriting and executing trusts;

(ix) establishing and supporting or aiding in the establishment and support of institutions, funds, trusts etc.

(x) acquisition, construction, maintenance and alteration of any building and works necessary for the purpose of the banking company;

(xi) selling, improving, managing, developing, exchanging, leasing, mortgaging, depositing of or turning into account or otherwise dealing with all or any part of the property and rights of the company;

(xii) acquiring and undertaking whole or any part of the business of any person or company;

(xiii) doing all such other things as are incidental or conductive to the promotion or advancement of the business of the banking company;

(xiv) any other business which the Central Government may specify by notification in the Official Gazette.

No banking company shall engage in any form of business other than those referred to above.

1.2 PROHIBITION OF TRADING (SECTION 8)

A banking company cannot directly or indirectly deal in the buying or selling or bartering of goods. However, it may buy, sell or barter in connection with the bills of exchange received for collection or negotiation or can undertake the administration of estates as executors, trustees or otherwise.

1.3 DISPOSAL OF NON-BANKING ASSETS (SECTION 9)

A banking company can only acquire immovable property for its own use. Other immovable properties acquired must be disposed off within seven years from the date of acquisition. However, in any particular case, the Reserve Bank of India may extend such period of seven years if it is satisfied, that such extension would be in the interest of the depositors of the banking company.

1.4 MANAGEMENT (SECTION 10)

Under section 10(a), not less than 51% of the total number of members of the board of directors of a banking company shall consist of persons having special knowledge or practical experience in one or more of the following fields :

1. Accountancy;
2. Agriculture and rural economy;
3. Banking;
4. Co-operation;
5. Economics;
6. Finance;
7. Law;
8. Small scale industry.

It is also required othat not less than two directors should have special knowledge or practical experience in respect of agriculture and rural economy and co-operation or small-scale industry. Under section 10(*b*)(1), every banking company shall have one of its directors as Chairman of its board of directors. The Chairman is entrusted with the management of the whole of the affairs of the banking company. Such Chairman is the whole-time employee of the banking company and can hold office for a period not exceeding five years. Other directors who are whole-time directors can hold office continuously for a period not exceeding eight years.

1.5 CAPITAL AND RESERVE

Requirement as to minimum paid-up capital and reserve (Section 11) : In the case of a banking company incorporated outside India and having a place or places of business in the city of Bombay or Calcutta or both, the aggregate value of its paid-up capital and reserve shall not be less than Rs. 20 lacs. Any other banking company incorporated outside India shall have aggregate value of paid-up capital and reserves amounting to Rs. 15 lacs or more. In case of any banking company incorporated in India having places of business in more than one State including any such place or places of business situated in the city of Bombay or Calcutta or both, the aggregate value of its paid-up capital and reserves shall not be less than Rs. 10 lacs. In case of a banking company incorporated in India and having all its places of business in one State and none of which is situated in the city of Bombay or Calcutta, the aggregate value of its paid-up capital and reserves shall be Rs. 1 lakh in respect of all its principal places of business plus Rs. 10,000 in respect of each of its other places of business situated in the same district in which it has its principal place of business plus Rs. 25,000 in respect of each place of business situated elsewhere in the State (however, such banking company does not need to maintain the aggregate value of paid-up capital and reserve more than Rs. 5 lacs). Any banking company incorporated outside India is required to deposit with the Reserve Bank either in cash or in the form of unencumbered approved securities or partly in cash and partly in securities, the minimum amount of paid-up capital and reserves which it has to maintain under section 11(2).

Regulation relating to authorized capital, subscribed capital and paid-up capital (Section 12) : The subscribed capital of a banking company cannot be less than one-half of the authorised capital and the paid-up capital cannot be less than one-half of the subscribed capital. The capital of the banking company consists of ordinary shares or equity shares and such preference shares which have been issued prior to the first day of July, 1944. The voting right of any single shareholder cannot exceed 1% of the total voting rights. Under section 13 of the Banking Regulation Act a banking company cannot pay out directly or indirectly commission, brokerage, discount, or remuneration in respect of any shares issued by it, an amount exceeding two and one-half per cent of the paid-up value of such shares.

1.6 RESERVE FUNDS (SECTION 17)

Every banking company incorporated in India is required to transfer atleast 25% of its profit to the reserve fund. The profit of the year as per the profit and loss account prepared under Section 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.

If any banking company makes any appropriation from the reserve fund or share premium account, it has to report to the Reserve Bank of India the reasons for such appropriation within 21 days.

1.7 RESTRICTION AS TO PAYMENT OF DIVIDEND

Before paying any dividend, a banking company has to write off completely all its capitalised expenses including preliminary expenses, organisation expenses, share-selling commission, brokerage, and amounts of losses incurred by tangible assets. However, a banking company may pay dividend on its shares without writing off -

1. the depreciation in the value of its investment in approved securities in any case where such depreciation has not actually been capitalised or accounted for as a loss;
2. the depreciation in the value of its investment in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company;
3. the bad debts in any case where adequate provision for such debts had been made to the satisfaction of the auditor of the banking company.

1.8 CASH RESERVE (SECTION 18)

Every non-scheduled bank has to maintain a cash reserve at least to the extent of 9% (as on 30.9.08) of its demand and time liabilities in India on the last Friday of the second preceding fortnight. Cash reserve can be maintained by way of balance in a current account with the Reserve Bank of India or by way of net balance in current accounts. Every non-scheduled bank has to submit a return showing the amount so held for cash reserve along with the particulars of its demand and time liabilities in India on such Friday before 20th day of every month. If any such Friday is a holiday under the Negotiable Instruments Act, 1881, such return is to be sent at the close of business on the preceding working day.

Every Scheduled Commercial Bank has to maintain cash reserve as per direction of the RBI issued under Section 42(IA) of the Reserve Bank of India Act, 1934. Computational technique of cash reserve ratio has been explained in Unit 4.

RBI revises this rate time to time.

1.9 LICENSING OF BANKING COMPANIES (SECTION 22)

A banking company can function in India if it holds a licence issued by the Reserve Bank of India in that behalf. Before granting any licence, the Reserve Bank may require to be satisfied by an inspection of the books of the company or otherwise that the following conditions are fulfilled :

(a) That the company is or will be in a position to pay its present or future depositors in full as their claims accrue;

(b) That the affairs of the company are not being conducted or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors;

(c) That the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors;

(d) That the company has adequate capital structure and earning prospects;

(e) That the public interest will be served by the grant of a licence to the company to carry on banking business in India.

(f) That having regard to the banking facilities available in the proposed principal area of banks already in existince in the area and other relevant factors, the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth.

Similarly, prior permission of the Reserve Bank of India is necessary to open a new place of business in India or to change the existing place of business situated in India. Also, no banking company incorporated in India can open a place of business outside India or change the existing place of business without prior permission of the Reserve Bank of India.

1.10 LIQUIDITY NORMS (SECTION 24)

Banking companies have to maintain sufficient liquid assets in the normal course of business. In order to safeguard the interest of depositors and to prevent banks from overextending their resources, liquidity norms have been settled and given statutory recognition. Every banking company has to maintain in cash, gold or unencumbered approved securities, an amount not less than 25% of its demand and time liabilities in India. However, this percentage is changed by the Reserve Bank of India from time to time considering the general economic conditions. This is in addition to the average daily balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act and in case of other banking companies,

RBI revises this rate time to time.

the cash reserve required to be maintained under Section 18 of the Banking Regulation Act.

1.11 RESTRICTION ON ACQUISITION OF SHARES IN OTHER COMPANY

A banking company cannot form any subsidiary except for one or more of the following purposes:

1. The undertaking of any business permissible for banking company to undertake.
2. Carrying on business of banking exclusively outside India with previous permission in writing of the Reserve Bank.
3. The undertaking of such other business which the Reserve Bank of India may permit with prior approval of the Central Government.

Other than formation of such subsidiary companies as mentioned above, a banking company cannot hold shares in any company either as pledge, mortgage, or absolute owner of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

1.12 RESTRICTION ON LOANS AND ADVANCES

Under Section 20 of the Banking Regulations Act, a banking company cannot grant any loans or advances on the security of its own shares. It cannot enter into any commitment for granting any loan or advance to or on behalf of -

(i) any of its directors.

(ii) any firm in which any of its directors is interested as partner, manager, employee or guarantor.

(iii) any company other than the subsidiary of the banking company, or a company registered under section 25 of the Companies Act or a Government company of which any of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest.

(iv) any individual in respect of whom any of its directors is a partner or a guarantor.

1.13 PROHIBITION OF CHARGE ON UNPAID CAPITAL AND FLOATING CHARGE ON ASSETS

Under Section 14 of the Banking Regulation Act, a banking company cannot create any charge upon any unpaid capital of the company. A banking company also cannot create a floating charge on the undertaking or any property of the company or any part thereof unless the creation of such floating charge is certified in writing by the Reserve Bank as not being detrimental to the interest of the depositors of such company (Section 14A).

1.14 UNCLAIMED DEPOSITS

Under Section 26 of the Banking Regulations Act, every banking company is required to submit a return in the prescribed form and manner to the Reserve Bank of India at the end of each calendar year of all accounts in India which could not be operated for 10 years. This report is to be submitted within 30 days after the close of each calendar year. In case of fixed deposit, such 10 years are to be reckoned from the date of expiry of the fixed period.

1.15 ACCOUNTS AND AUDIT

Sections 29 to 34A of the Banking Regulation Act deal with accounts and audit. At the end of each financial year or at the expiration of a period of 12 months ending with such date as the Central Government may by notification in the Official Gazette specify in this behalf, every banking company incorporated in India in respect of business transacted by it shall prepare with reference to that year or period, a Balance Sheet and Profit and Loss Account as on the last working day of that year or the period in the forms set out in the Third Schedule or as near thereto as circumstances permit. Similarly, every banking company incorporated outside India is required to prepare Balance Sheet and Profit and Loss Account in respect of all business transacted through its branches in India. Form A of the Third Schedule deals with form of Balance Sheet and Form B of the Third Schedule deals with form of Profit and Loss Account. It is important to note that of late a set of new forms have been devised for balance sheet and profit and loss account of the banking companies and the Reserve Bank of India has issued guidelines to follow the new forms with effect from accounting year ending on 31st March, 1992. The new forms will be discussed at the appropriate place.

The statement of accounts must be signed by the manager or principal officer and by at least three or all directors if there are not more than three directors in case of a banking company incorporated in India. In case of a banking company incorporated outside India, the statement of accounts must be signed by the manager or agent of the principal office of the company in India.

Under Section 30 of the Banking Regulation Act, the Balance Sheet and Profit and Loss Account prepared in accordance with Section 29 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies. Every banking company is required to take previous approval of the Reserve Bank of India before appointing, re-appointing or removing any auditor or auditors. In addition, the Reserve Bank can order special audit of the banking companies accounts if it thinks fit in the public interest of the banking company or its depositors. Every banking company is required to furnish three copies of its accounts and balance sheet prepared in accordance with the provisions of Section 29 together with the auditors' report to the Reserve Bank of India within three months from the end of the accounting period or year. Also, a banking company has to submit three copies of such accounts and balance sheet together with auditor's report to the Registrar of Companies under Section 31 of the Banking Regulation Act.

Moreover, every banking company incorporated outside India has to display in a conspicuous place in its principal office and its every branch in India, a copy of its audited Balance Sheet and Profit and Loss Account not later than the first Monday in the month of August of any year. Every such copy so displayed can be replaced only by a copy of the subsequent Balance Sheet and Profit and Loss Account.

SELF-EXAMINATION QUESTIONS

I. Objective Type Questions

1. As per the Banking Regulations Act, 1949, a bank can engage in the following banking business
   (a) Borrowing and raising of money
   (b) Dealing in bills of exchange, hundies, promissory notes etc.
   (c) Carrying on and transacting every kind of guarantee and indemnity business
   (d) All of the above
2. Every banking company in India is required to transfer atleast ______ of its current year's profit to the reserve fund
   (a) 10%
   (b) 20%
   (c) 30%
   (d) 40%
3. A banking company can pay dividend on its shares
   (a) after writing off all its capitalised expenses including preliminary expenses
   (b) After charging depreciation on its investments
   (c) After charging bad debts where adequate provisions has been made to the satisfaction of the auditor.
   (d) Before charging depreciation on its investments and writing off all its capitalised expenses.

[**Answer 1.** (d), **2.** (b), **3.** (a)]

II. Short Answer Type Questions

5. State the amount of minimum paid up capital and reserve to be maintained by a bank in the following circumstances :
   (i) a foreign bank having place of business at Calcutta;
   (ii) a bank incorporated in India having places of business in Calcutta and Patna;
   (iii) a foreign bank having place of business in Ludhiana and Srinagar;
   (iv) a bank incorporated in India having head office at Patna and branches at Ranchi, Gaya and Dhanbad (all in the State of Bihar, but in different districts).
6. What do you mean by cash reserve? How much cash reserve should a non-scheduled bank maintain? Also mention the liquidity norm to be followed by a bank.

III. Long Answer Type Questions

7. Explain briefly the provisions relating to accounts and amounts as detailed out in the Banking Regulations Act, 1949.
8. What do you mean by 'banking'? What are 'scheduled banks'? What facilities does the RBI offer to the scheduled banks?

UNIT - 2: BOOKS OF ACCOUNTS, RETURNS AND FORMS OF FINANCIAL STATEMENTS

Learning Objectives

After studying this unit, you will be able to:

- Learn the main characteristics of a bank's system of books keeping.
- Understand the methods in which all detailed accounts in subsidiary books and principal books are maintained by a bank and their purposes.
- Make a list of various other registers, departmental journals and memorandum books generally maintained by a bank.
- Familiarize with the monthly, quarterly and annual returns filed by a bank to the RBI.

Recommended Text - Guidance Note on Audit of Banks, ICAI.

2.1 INTRODUCTION

The book-keeping system of a banking company is substantially different from that of a trading or manufacturing enterprise. A bank maintains a large number of accounts of various types for its customers. As a safeguard against any payment being made in the account of a customer in excess of the amount standing to his credit or a cheque of a customer being dishonoured due to a mistake in the balance in his account, it is necessary that customers' accounts should be kept up-to-date and checked regularly. In many other mercantile enterprises, books of primary entry (*i.e.,* day books) are generally kept up-to- date while their ledgers including the general ledger and subsidiary ledgers for debtors, creditors etc. are written afterwards. A bank cannot afford to ignore its ledgers particularly those concerning the accounts of its customers and has to enter into the ledgers every transactions as soon as it takes place. In bank accounting, relatively less emphasis is placed on day books. These are merely treated as a means to an end-the end being to keep up-to-date detailed ledgers and to balance the trial balance everyday and to keep all control accounts in agreement with the detailed ledgers.

In this Unit, we shall concentrate on accounting system followed in, bank and books of accounts maintained for that purpose. That apart, we shall take a stock of the returns which a bank is required to file with the Reserve Bank. Another important aspect in the bank accounts is preparation of final accounts. The third schedule to the Banking Regulation Act provides formats for that purpose. Formats of bank final accounts are also covered in this Unit.

2.2 MAIN CHARACTERISTICS OF A BANK'S BOOK-KEEPING SYSTEM

The main characteristics of a bank's system of book-keeping are as follows :-

(a) **Voucher posting -** Entries in the personal ledger are made directly from vouchers instead of being posted from the books of prime entry.

(b) **Voucher summary sheets -** The vouchers entered into different personal ledgers each day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.

(c) **Daily trial balance -** The general ledger trial balance is extracted and agreed every- day.

(d) **Continuous checks -** All entries in the detailed personal ledgers and summary sheets are checked by persons other than those who have made the entries. A considerable force of such check is employed, with the general result that most clerical mistakes are detected before another day begins.

(e) **Control Accounts -** A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, agreed with general ledger control accounts.

(f) **Double voucher system -** Two vouchers are prepared for every transaction not involving cash - one debit voucher and another credit voucher.

2.3 PRINCIPAL BOOKS OF ACCOUNTS

The *General ledger* contains accounts of all personal ledgers, the profit and loss account and different asset accounts. The accounts in the general ledger are arranged in such an order that a balance sheet can be readily prepared therefrom. There are certain additional accounts known as contra accounts which are a feature of bank accounting. These are kept with a view to keep control over transactions which have no direct effect on the bank's position *e.g.,* letters of credit opened, bills received or sent for collection, guarantees given, etc.

Profit and loss ledger - Some banks keep one account for profit and loss in the General Ledger and maintain separate books for the detailed accounts. These are columnar books having separate columns for each revenue or expense head. Other banks maintains separate books for debits and credits. These books are posted from vouchers. The total of debits and credits posted are entered into the Profit and Loss Account in the General Ledger. In some banks, the revenue accounts are also maintained in the General Ledger itself, while in some others broad revenue heads are kept in the General Ledger and their details are kept in subsidiary ledgers.

For management purposes the account heads in the Profit and Loss ledgers are more detailed than those shown in the published Profit and Loss Account of the bank. For example, there will be separate accounts for basic salary, dearness allowance and various other allowances, which are grouped together in the final accounts. Similarly, various accounts concerning general charges, interest paid, interest received, etc., are maintained separately in the Profit and Loss ledgers.

2.4 SUBSIDIARY BOOKS

Personal Ledgers - Separate ledgers are maintained by a bank for different types of accounts. For example, there are separate ledgers for Current Accounts, Fixed Deposits (often further classified by length of period of deposit), Cash Certificates, Loans, Overdrafts, etc. As has been mentioned earlier, these ledgers are posted directly from vouchers, and all the vouchers entered in each ledger in a day are summarised into voucher summary sheets. The voucher summary sheets are prepared in the department which originates the transaction, by persons other than those who write the ledgers. They are subsequently checked with the vouchers by different persons generally unconnected with the writing up of ledgers on the Voucher Summary Sheets.

Bill Registers - Details of different types of bills are kept in separate registers which have suitable columns. For example, bills purchased, inward bills for collection, outward bills for collection etc. are entered serially on day-to-day basis in separate registers. In case of bills purchased or discounted, party-wise details are also kept in normal ledger form. This is done to ensure that the sanctioned limits of parties are not exceeded.

Entries in these registers are made by reference to the original documents. A voucher for the total amount of the transaction of each day is prepared in respect of each register. This voucher is entered in the Day Book. When a bill is realised or returned, its original entry in the register is marked off. A daily summary of such realisations or returns is prepared in separate registers whose totals are taken to vouchers which are posted in the Day Book.

In respect of bills for collection, contra vouchers reflecting both sides of the transaction are prepared at the time of the original entry, and this is reversed on realisation.

Outstanding entries are summarised frequently, usually twice a month, and their total is agreed with the balance of the respective control accounts in the General Ledger.

2.5 OTHER SUBSIDIARY REGISTERS

There are different registers for various types of transactions. Their number, volume and details will differ according to the individual needs of each bank. For example, there will be registers for :-

(a) Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.

(b) Demand drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.

(c) Letters of Credit.

(d) Letters of Guarantee.

Entries into these registers are made from original documents which are also summarized on vouchers everyday. These vouchers are posted into Day Book.

Outstanding entries are summarised frequently and their total agreed with the control heads in the General ledger.

2.6 DEPARTMENTAL JOURNALS

Each department of the Bank maintains a journal to note the transfer entries passed by it. These journals are memoranda books only, as all the entries made there are also made in the Day Book through Voucher Summary Sheets. Their purpose is to maintain a record of all the transfer entries originated by each department. For example, the Loans and Overdraft Section will pass transfer entries for interest charged on various accounts every month, and as all these entries will be posted in the journal of that department, the office concerned can easily find out the accounts in respect of which the interest entry has been passed. Since all vouchers passed during the day are entered into the Day Book only in a summary form, it may not be possible to get this information from the Day Book without looking into the individual vouchers. Moreover, as the number of departments in a banks is quite large, the Day Book may not be accessible at all times to all departments.

As has been mentioned earlier, two vouchers are generally made for each transaction by transfer entry, one for debit and the other for credit. The vouchers are generally made by and entered into the journal of the department which is affording credit to the other department. For example, if any amount is to be transferred from Current Account of a customer to his Saving Bank Account, the voucher will be prepared by the Current Accounts Department and entered in the journal of that department.

2.7 OTHER MEMORANDA BOOKS

Besides the books mentioned above, various departments of the bank have to maintain a number of memoranda books to facilitate their work. Some of the important books are described below :-

Cash Department

(a) Receiving Cashiers' cash book

(b) Paying Cashiers' cash book

(c) Main cash book

(d) Cash Balance book

The main Cash Book is maintained by persons other than the cashiers. Each cashier keeps a separate cash book. When cash is received, it is accompanied by pay-in-slip or other similar document. The cashier makes the entry in his book which is checked by the chief cashier. The pay-in-slip then goes to the Main Cash Book writer who makes an entry in his books. The cash book checker checks the entry with the slip and then the counter-foil of the slip is returned back to the customer and the foil is sent to the appropriate department for entering into the ledger. The foil is used as a voucher. Cash is paid against a cheque or other document (e.g. traveller's cheque, demand draft, pay order, etc.) after it has been duly passed and entered in the appropriate account in the ledger. Cheques, demand drafts, pay orders, etc. are themselves used as vouchers.

Quick Payment System - Banks introduce different systems so that their customers may receive payment of cash etc. quickly. The most prevalent system is the teller system. Under this system tellers keep cash as well as ledger cards and the specimen signature cards of each customer in respect of Current and Saving Bank Accounts. A teller is authorised to make payment upto a particular amount, say, Rs. 1,000. On receipt of the cheque, he checks it, passes it for payment, enters it in the ledger card and makes the payment to customer. The teller also receives cash deposited in these accounts.

Outward Clearing : (*a*) A Clearing Cheques Received Book for entering cheques received from customers for clearing.

(*b*) Bankwise list of the above cheques, one copy of which is sent to the Clearing House together with the cheques.

A person checks the vouchers (foil of pay-in slips) and lists with the Clearing Cheque Received Book. The vouchers are then sent to appropriate departments, where customers' accounts are immediately credited. If any cheque is received back unpaid the entry is reversed. Normally, no drawings are allowed against clearing cheques deposited on the same day but exceptions are often made by the manager in the case of established customers.

Inward Clearing - Cheques received are checked with the accompanying lists. They are then distributed to different departments and the number of cheques given to each department is noted in a Memo Book. When the cheques are passed and posted into ledgers, their number is independently agreed with the Memo Book. If any cheques are found unpayable, they are returned back to the Clearing House. The cheques themselves serve as vouchers.

Loans & Overdraft Departments

(a) Registers for shares and other securities held on behalf of each customer.

(b) Summary Books of Securities giving details of Government securities, shares of individual companies etc.

(c) Godown registers maintained by the godown-keeper of the bank.

(d) Price register giving the wholesale price of the commodities pledged with the bank.

(e) Overdraft Sanction register.

(f) Drawing Power book.

(g) Delivery Order books.

(h) Storage books.

Deposits Department

(a) Account Opening & Closing registers.

(b) For Fixed Deposits, Rate register giving analysis of deposits according to rates.

(c) Due Date Diary.

(d) Specimen signature book.

Establishment department

(a) Salary and allied registers, such as attendance register, leave register, overtime register, etc.

(b) Register of fixed assets, e.g., furnitures and fixtures, motor cars, vehicles, etc.

(c) Stationery registers.

(d) Old records registers.

General

(a) Signature book of bank's officers.

(b) Private Telegraphic Code and Cyphers.

2.8 STATISTICAL BOOKS

Statistical records kept by different banks are in accordance with their individual needs. For example, there may be books for recording (*i*) average balance in loans and advances etc., (*ii*) Deposits received and amount paid out each month in the various departments, (*iii*) Number of cheques paid, (*iv*) Number of cheques, bills and other items collected.

The above is not an exhaustive list of accounting records kept by a bank.

2.9 RETURNS TO BE FILED BY BANKING COMPANIES

Apart from the weekly return to be filed by scheduled banks, all banking companies have to file the following returns with the Reserve Bank :

(a) Monthly return of unsecured loans and advances granted to companies is which any of the banking company's directors is interested as director, managing agent or guarantor. (S. 20)

(b) Monthly return of assets maintained in accordance with S. 24 and time and demand liabilities at the close of business on every Friday. (S. 24)

(c) Quarterly return of assets and liabilities at the close of business on the last Friday of every quarter. (S. 25)

(d) Annual return of unclaimed accounts which have not been operated upon for 10 years or more. (S. 26)

(e) Monthly return of assets and liabilities at the close of business on the last Friday of every month. (S. 27)

(f) Annual return of remuneration paid to directors and the first ten highest paid officers. (Rule 5)

(g) Quarterly return of officers in India. (Rule 13)

(h) Any other statement or information as may be required by the Reserve Bank. (S. 27)

2.10 FORMS OF BALANCE SHEET AND PROFIT AND LOSS ACCOUNT

With the nationalisation of major commercial banks and changes brought about in the economic and financial policies by the Government, the environment in which the banks operate has undergone a complete change. However, there was little effort to bring about a change in the financial statements of banks to reflect the reality of the impact of the environment. There were suggestions emphasising a need for revising formats in which banks publish their financial statements as prescribed under the Banking Regulation Act, 1949. A Committee under the Chairmanship of Shri A. Ghosh, Deputy Governor, RBI, was constituted to examine, *inter alia* the desirability of greater or full disclosure in the published accounts of banks having regard to the need for disclosure, public accountability of banks, requirement and maintenance of confidentiality between banker and customer and the requirement of maintaining the reputation and credit-worthiness of banks. The Committee after due deliberation has suggested suitable changes/amendments in the forms of balance sheet and profit and loss account of banks, having regard to :

1. need for better disclosure
2. expansion of banking operations both area-wise and sector-wise over the period
3. need for improving the presentation of accounts etc.

The revised formats are given below which include Form A for Balance Sheet, Form B for Profit and Loss Account and eighteen other schedules of which two relates to notes and accounting policies.

New Revised Formats
The Third Schedule

(See Section 29)
Form 'A'

Form of Balance Sheet

Balance Sheet of ______________________ (here enter name of the Banking company)

Balance Sheet as on 31st March (Year) (000's omitted)

	Schedule	As on 31.3.... (Current year)	As on 31.3...... (Previous year)
Capital & Liabilities			
Capital	1		
Reserve & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			
Assets			
Cash and balances with Reserve Bank of India	6		
Balance with banks and Money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

Schedule 1 - Capital

	As on 31.3... (Current year)	As on 31.3... (Previous year)
I. For Nationalised Banks		
Capital (Fully owned by Central Government)		
II. For Banks Incorporated outside India		
Capital		
(i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)		
(ii) Amount of deposit kept with the RBI under Section 11(2) of the Banking Regulation Act, 1949	____	____
Total	____	____
III. For other Banks		
Authorised Capital		
(___Shares of Rs. ____ each)		
Issued Capital		
(___Shares of Rs. ____each)		
Subscribed Capital		
(____Shares of Rs. ___ each)		
Called-up Capital		
(____Shares of Rs. ___ each)		
Less : Calls unpaid		
Add : Forfeited shares	____	____
Total	____	____

Schedule 2 - Reserves and Surplus

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Statutory Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
II.	**Capital Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
III.	**Share Premium**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
IV.	**Revenue and other Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
V.	**Balance in Profit and loss Account**		
	Total : (I, II, III, IV and V)		

Schedule 3 - Deposits

			As on 31.3... (Current year)	As on 31.3... (Previous year)
A.	**I.**	**Demand Deposits**		
		(i) From banks		
		(ii) From others		
	II.	**Savings Bank Deposits**		

	III.	**Term Deposits**		
		(i) From Banks		
		(ii) From others	______	______
		Total :(I, II and III)	______	______
B.	(i)	Deposits of branches in India		
	(ii)	Deposits of branches outside India	______	______
		Total	______	______

Schedule 4 - Borrowings

			As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Borrowings in India**			
	(i)	Reserve Bank of India		
	(ii)	Other banks		
	(iii)	Other institutions and agencies		
II.	**Borrowings outside India**		______	______
	Total : (I and II)		______	______
	Secured borrowings included in I & II above - Rs.			

Schedule 5 - Other Liabilities and Provisions

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	Bills payable		
II.	Inter-office adjustments (net)		
III.	Interest accrued		
IV.	Others (including provisions)	______	______
	Total	______	______

Schedule 6 - Cash and Balances with Reserve Bank of India

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Cash in hand** (including foreign currency notes)		

II. Balances with Reserve Bank of India

(i) In Current Account		
(ii) In Other Accounts	________	________
Total : (I & II)	________	________

Schedule 7 - Balances with Banks & Money at Call & Short Notice

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I. In India		
(i) Balances with banks		
(a) in Current Accounts		
(b) in Other Deposit Accounts		
(ii) Money at call and short notice		
(a) with banks		
(b) with other institutions	________	________
Total : (i & ii)	________	________
II. Outside India		
(i) In Current Accounts		
(ii) in other Deposits Accounts		
(iii) Money at call and short notice	________	________
Total	________	________
Grand Total (I & II) :	________	________

Schedule 8 - Investments

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I. Investments in India in		
(i) Government securities		
(ii) Other approved securities		
(iii) Shares		

(iv) Debentures and Bonds

(v) Subsidiaries and/or joint ventures

(vi) Others (to be specified) ____________ ____________

Total ____________ ____________

II. Investments outside India in

(i) Government securities
(Including local authorities)

(ii) Subsidiaries and/or joint ventures abroad

(iii) Other investments (to be specified) ____________ ____________

Total ____________ ____________

Grand Total :(I & II) ____________ ____________

Schedule 9 - Advances

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
A. (i) Bills purchased and discounted		
(ii) Cash credits, overdrafts and loans repayable on demand		
(iii) Term loans	____________	____________
Total	____________	____________
B. (i) Secured by tangible assets		
(ii) Covered by Bank/Government Guarantees		
(iii) Unsecured	____________	____________
Total	____________	____________
C. I. Advances in India		
(i) Priority Sectors		
(ii) Public Sector		
(iii) Banks		
(iv) Others	____________	____________
Total	____________	____________

II. Advances outside India

(i) Due from banks

(ii) Due from others

(a) Bills purchased and discounted

(b) Syndicated loans

(c) Others

Total

Grand Total :(C. I & II)

Schedule 10 - Fixed Assets

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I. Premises		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
II. Other Fixed Assets (including Furniture and Fixtures)		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
Total : (I & II)		

Schedule 11 - Other Assets

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I. Inter-office adjustments (net)		
II. Interest accrued		
III. Tax paid in advance/tax deducted at source		
IV. Stationery and stamps		

V.	Non-banking assets acquired in satisfaction of claims		
VI.	Others*	________	________
	Total	________	________

*In case there is any unadjusted balance of loss the same may be shown under this item with appropriate foot-note.

Schedule 12 - Contingent Liabilities

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	Claims against the bank not acknowledged as debts		
II.	Liability for partially paid investments		
III.	Liability on account of outstanding forward exchange contracts		
IV.	Guarantees given on behalf of constituents		
	(a) In India		
	(b) Outside India		
V.	Acceptances, endorsements and other obligations		
VI.	Other items for which the bank is contingently liable	________	________
	Total	________	________

Form 'B'
Form of Profit & Loss Account
for the year ended 31st March

('000 omitted)

		Schedule	Year ended As on 31.3.... (Current year)	Year ended As on 31.3.... (Previous year)
I.	**Income**			
	Interest earned	13		
	Other income	14	________	________
	Total		________	________

II.	**Expenditure**			
	Interest expended	15		
	Operating expenses	16		
	Provisions and contingencies			
	Total			
III.	**Profit/Loss**			
	Net profit/loss (—) for the year			
	Profit/Loss (—) brought forward			
	Total			
IV.	**Appropriations**			
	Transfer to statutory reserves			
	Transfer to other reserves			
	Transfer to Government/Proposed dividends			
	Balance carried over to balance sheet			
	Total			

Schedule 13 - Interest Earned

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Interest/discount on advances/bills		
II.	Income on investments		
III.	Interest on balances with Reserve Bank of India and other inter-bank funds		
IV.	Others		
	Total		

Schedule 14 - Other Income

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Commission, exchange and brokerage		
II.	Profit on sale of investments		
	Less : Loss on sale of investments		
III.	Profit on revaluation of investments		
	Less : Loss on revaluation of investments		
IV.	Profit on sale of land, building and other assets		
	Less : Loss on sale of land, building and other assets		
V.	Profit on exchange transactions		
	Less : Loss on exchange transactions		
VI.	Income earned by way of dividends etc. from subsidiaries/companies and/or joint ventures abroad/in India		
VII.	Miscellaneous Income		
	Total		

Note : Under items II to V loss figures may be shown in brackets.

Schedule 15 - Interest Expended

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Interest on deposits		
II.	Interest on Reserve Bank of India/inter-bank borrowings		
III.	Others		
	Total		

Schedule 16 - Operating Expenses

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Payments to and provisions for employees		
II.	Rent, taxes and lighting		
III.	Printing and stationery		
IV.	Advertisement and publicity		
V.	Depreciation on Bank's property		
VI.	Director's fees, allowances and expenses		
VII.	Auditor's fees and expenses (including branch auditor's fees and expenses)		
VIII.	Law Charges		
IX.	Postages, Telegrams, Telephones, etc.		
X.	Repair and maintenance		
XI.	Insurance		
XII.	Other expenditure		
	Total		

In 'Notes on Accounts', the following disclosures should be made :

Notes on Accounts

Capital adequacy ratio	The sum of Tier I and Tier II capital should be taken as the numerator while the denominator should be arrived at by converting the minimum capital charge for open exchange position stipulated by the Exchange Control Department of the 'notional risk assets' by multiplying it by 12.5 (the reciprocal of the minimum capital to risk-weighted assets ratio of 8%) and then adding the resulting figure to the weighted assets, compiled for credit risk purposes.

Capital adequacy ratio – Tier I Capital	Tier I capital should be taken as the numerator while the denomionator should be arrived at by converting the minimum capital charge for open exchange position stipulated by the Exchange Control Department of the RBI into 'notional risk assets' by multiplying it by 25 (the reciprocal of the minimum capital to risk-weighted assets ratio of 4%) and then adding the resulting figure to the weighted assets, compiled for credit risk purposes.
Capital adequacy ratio-Tier II Capital Amount of subordinated debt raised as	This item should be shown by way of explanatory notes/remarks in the balance sheet as well as in
Tier II capital	Schedule 5 relating to 'Other Liabilities and Provisions'.
Percentage of shareholding of the	
Government of India in the nationalized banks Gross value of investments in India and outside India, the aggregate of provisions for depreciation separately on investments in India and outside India and the net value of investments in India and outside India	
Percentage of net NPAs to net advances	Net NPAs mean gross NPAs *minus* (balance in Interest Suspense Account *plus* DICGC/ECGC claims received and held pending adjustment *plus* part payment received and kept in Suspense Account *plus* provisions held for loan losses).
Movements in NPAs	The disclosures should include the opening balances of Gross NPAs (after deducting provisions held, interest suspense account, DICGC claims received and part payments received and kept in suspense account) at the beginning of the year, reductions/additions to the NPAs during the year and the balances at the end of the year.

The amount of provisions made towards NPA, toward depreciation in the value of investments and the provisions towards tax during the year	These provisions along with other provisions and contingencies should tally with the aggregate of the amount held under 'Provisions and income-contingencies' in the profit and loss account.
Maturity pattern of investment securities	Banks may follow the maturity buckets prescribed in the guidelines on Assets-Liability Management System (forwarded vide Circular DBOD.BP.BC.8/21.04.098/99 dated February 10, 1999) for disclosure of maturity pattern.
Maturity pattern of loans and advances	Banks may follow the maturity buckets prescribed in the guidelines on Assets-Liability Management System (forwarded vide Circular DBOD.BP.BC.8/21.04.098/99 dated February 10, 1999) for disclosure of maturity pattern.
Foreign currency assets and liabilities	In respect of this item, the maturity profile of the bank's foreign currency liabilities should be given.
Maturity pattern of deposits	Banks may follow the maturity buckets prescribed in the guidelines on Asset-Liability Management System (forwarded vide Circular DBOD.BP.BC.8/21.04.98/99 dated February 10, 1999) for disclosure of maturity pattern.
Maturity pattern of borrowings	Banks may follow the maturity buckets prescribed in the guidelines on Asset-Liability Management System (forwarded vide Circular DBOD.BP.BC.8/21.04.098/99 dated February 10, 1999) for disclosure of maturity pattern.
Lending to sensitive sectors	Banks should disclose lending to sectors which are sensitive to asset price fluctuations. These should include advances to sectors such as capital market, estate, etc. and such other sectors to be defined as 'sensitive' by the RBI from time to time.
Interest income as a percentage to working funds	Working funds mean total assets as on the date of balance sheet (excluding accumulated losses, if any).
Non-interest income as a percentage to	

working funds	
Operating profit as a percentage to (interest working funds	Operating profit means total income minus expenses plus operating expenses etc.)
Return on assets	Return on assets means net profit divided by average of total assets as at the beginning and end of the year.
Business (deposits plus advances) per employee	This means fortnightly average of deposits (excluding inter-bank deposits) and advances divided by number of employees as on the date of balance sheet.
Profit per employee	

Depreciation on Investments	As per RBI Circular DBOD No.BP.BC.38/21.04.018/2001-02, dated October 27, 2001, bank should make disclosure on the provision for depreciation on investments in the following formats.
	Opening Balance (as on April, 01) ………………………
	Add: Provisions made during the year: ………………………………………
	Less: Write-off, write back of excess provisions during the year …………………………….
	Closing balance (as on March 31) ………………………………………
Corporate Debut Restructured Accounts	Banks should disclose in their published annual Balance Sheets, under "Notes on Accounts", the following information in respect of corporate debt restructuring undertaken during the year.
	a. Total amount of loan assets subjected to restructuring under CDR.
	[(a) = (b)+(c) +(d)]
	b. The amount of standard assets subjected to CDR.
	c. The amount of sub-standard assets subjected to CDR.
	d. The amount of doubtful assets subjected to CDR.
	Disclosures in the Notes on Account to the Balance Sheet pertaining to restructured/rescheduled accounts apply to all accounts restructured/rescheduled during the year. While banks should ensure that they comply with the minimum disclosures prescribed, they may make more disclosures than the minimum prescribed.
Non SLR Investment	Banks should make the following disclosures in the 'Notes on Accounts' of the balance sheet in respect of their non SLR investment portfolio, with effect from the financial year ending 31 March, 2004.

Issuer Composition of Non SLR Investments

No.	Issuer	Amount	Extent of private placement	Extent of 'below investment grade' securities	Extent of 'unrated Securities	Extent of 'unlisted securities
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1.	PSUs					
2.	FIs					
3.	Banks					
4.	Private corporates					
5.	Subsidiaries/Joint Ventures					
6.	Others					
7.	Provision held towards depreciation		XXX	XXX	XXX	XXX
	Total*					

Note:

1. *Total under column 3 should tally with the total of investments included under the following categories in Schedule 8 to the balance sheet:
   a. Shares
   b. Debentures & Bonds
   c. Subsidiaries/Joint Ventures
   d. Others

2. Amounts reported under columns 4,5,6 and 7 above may not be mutually exclusive.

Non performing non-SLR investments

Particulars	Amount *(Rs. Crore)*
Opening balance	

	Additions during the year since 1* April
	Reductions during the above period
	Closing balance
	Total provisions held
Disclosure for exposure limit	The bank should make appropriate disclosures in the "Notes on Account" to the annual financial statements in respect of the exposures where the bank had exceeded the prudential exposure limits during the year.

Notes and Instructions for Compilation

General instructions

1. Formats of Balance Sheet and Profit and Loss Account cover all items likely to appear in the statements. In case a bank does not have any particular item to report, it may be omitted from the formats.

2. Corresponding comparative figures for the previous year are to be disclosed as indicated in the format. The words "current year" and "previous year" used in the format are only to indicate the order of presentation and may appear in the accounts.

3. Figures should be rounded off to the nearest thousand rupees.

4. Unless otherwise indicated, the banks in these statements will include banking companies, nationalised banks, State Bank of India, Associate Banks and all other institutions including co-operatives carrying on the business of banking whether or not incorporated or operating in India.

5. The Hindi version of the balance sheet will be part of the annual report.

2.11 NOTE CONTAINING GUIDELINES OF RESERVE BANK OF INDIA FOR COMPILATION OF FINANCIAL STATEMENTS

Given below are the compilation notes of the Reserve Bank of India for balance sheet and profit and loss account as per the revised formats.

D. Note containing guidelines of RBI for compilation of Financial Statements
Balance Sheet

Item	*Schedule*	*Coverage*	*Notes and instructions for compilation*
Capital	1	**Nationalised Banks** (Fully Owned by Central	The capital owned by Central Government as on the date of the Balance Sheet including

		Government)	contribution from Government, if any, for participating in World Bank Projects should be shown.
		Banking companies incorporated outside	(*i*) The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head.
		Other Banks (Indian) Authorised Capital (....Shares or Rs. each) Issued Capital (..Shares of Rs......each) subscribed Capital (......Shares of Rs.....each) Called up Capital (...........Shares of Rs........each. Less : Calls unpaid........Add: Forfeited shares.....Paid up to capital.........	(*ii*) The amount of deposits kept with RBI, under sub-section 2 of section 11 of the Banking Regulation Act, 1949 should also be shown. Authorised, Issued, Subscribed, Called-up Capital should be given separately. Calls-in-arrears will be deducted from Called up capital while the paid-up value of forfeited shares should be added thus arriving at the paid-up capital. Where necessary, items which can be combined should be shown under one head for instance 'Issued and Subscribed Capital'. **Notes - General** The changes in the above items, if any, during the year, say, fresh contribution made by Government, fresh issue of capital, capitalisation of reserves, etc. may be explained in the notes.
Reserves and Surplus	2	**(I) Statutory Reserves**	Reserves created in terms of Section 17 or any other section of Banking Regulation Act must be separately disclosed.
		(II) Capital Reserves	The expression 'capital reserves' shall not include any amount regarded as free for distribution through the profit and loss account. Surplus on revaluation should be treated as Capital Reserves. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves. Surplus on translation of the financial statements of foreign branches (which

	includes fixed assets also) is not a revaluation reserve.
(III) Share Premium	Premium on issue of share capital may be shown separately under this head.
(IV) Revenue and other Reserves	The expression 'Revenue Reserve' shall mean any reserve other than capital reserve. This item created will include all reserves other than those separately classified. The expression Reserve shall not include any amount retained by way of providing renewals or diminution in value of assets or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. Excess provision towards depreciation on investments should be transferred to 'Investment Fluctuations Reserve Account' which should be shown as a separate item under the head 'Revenue and Other Reserves'. The amount held in 'Investment Fluctuation Reserve Account' could be utilized to meet the depreciation requirement on investment in securities in future. Extra provision needed in the event of depreciation in the value of the investment should be debited to the Profit and Loss Account and if required, an equivalent amount may be transferred from the 'Investment Fluctuation Reserve Account' to the Profit and Loss Account as a 'below the line' item after determining the profit for the year.
(V) Balance of Profit	Includes balance of profit after appropriations. In case of loss the balance may be shown as a deduction. **Notes – General** Movements in various categories of Reserves should be shown as indicated in

			the schedule
Deposits	3 **A.**	**(I) Demand Deposits**	
		(i) from banks	Includes all bank deposits repayable on demand.
		(ii) from others	Includes all demand deposits of the non-bank sectors. Credit balances in over-drafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, certificates of deposits, etc. are to be included under this category.
		(II) Saving Bank Deposits	
		(III) Term Deposits	
		(i) from banks	Includes all types of bank deposits repayable after a specified term.
		(ii) from others	Includes all types of deposits of the non-bank sector repayable after a specified term. Fixed deposits, cumulative and recurring deposits, cash certificates, certificates of deposits, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non-resident deposits accounts, etc. are to be included under this category.
	B.	(i) Deposits of branches in India	The total of these two items will agree with the total deposits.
		(ii) Deposits of branches outside India	
			Notes – General
			(*a*) Interest payable on deposits which is accrued but not due should not be included but shown under other liabilities.
			(*b*) Matured time deposits and cash certificates, etc. should be treated as demand deposits.

			(*c*) Deposits under special schemes should be included under term deposits if they are not payable on demand. When each deposits have matured for payments they should be shown under demand deposits.
			(*d*) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks which may or may not have a presence in India.
Borrowings	4	**(I) Borrowings in India**	
		(i) Reserve Bank of India	Includes borrowings/refinance obtained from Reserve Bank of India.
		(ii) Other banks	Includes borrowings/refinance obtained from commercial banks (including cooperative banks).
		(iii) Other institutions and agencies	Includes borrowings/refinance obtained from Industrial Development Bank of India. Export-Import Bank of India, National Bank for Agriculture and Rural Development and other institutions, agencies (including liability against participation certificates, if any)
		(II) Borrowings outside India	Includes borrowings of India branches abroad as well as borrowings of foreign branches.
		Secured borrowings included above	This item will be shown separately. Includes secured borrowings/refinance in India and outside India.
			Notes – General
			(*i*)The total of I & II will agree with the total borrowings shown in the balance sheet.
			(*ii*) Inter-office transactions should not be shown as borrowings.
			(*iii*) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc. should be classified depending upon documentation, as 'deposits' 'borrowings',

			etc. (*iv*) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head 'Borrowings'. Hence, advances will be shown at the gross amount on the assets side
Other liabilities and provisions	5	**I.** Bills payable	Includes drafts, telegraphic transfers, travellers' cheques, mail transfers payable, pay slips, bankers cheques and other miscellaneous items.
		II. Inter-office adjustment (net)	The inter-office adjustments balance, if in credit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. In working out the net position, credit entries outstanding for more than five years in inter-branch accounts should be segregated and transferred to a separate Blocked Account. While arriving at the net amount of inter-branch transactions for inclusion under Schedule 5 or 11 as the case may be, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries.
		III. Interest accrued	Includes interest accrued but not due on deposits and borrowings.
		IV. Others (including provisions)	(i) Includes the net provision for income tax and other taxes like interest tax (less advance payment tax deducted at source etc.), surplus in aggregate in provisions for bad debts provision account, surplus in aggregate in provisions for depreciation in securities, contingency funds

which are not disclosed as a reserve but are actually in the nature of reserves, proposed dividend/transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and fund kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance etc. Certain types of deposits like staff security deposits, margin deposits, etc. where the repayment is not free, should also be included under this head.

(ii) Provisions towards standard assets should be shown separately as 'Contingent Provisions against Standard Assets' under this ahead.

(iii) Amount of subordinated debt raised as Tier II capital should be shown in Schedule 5 as well as by way of explanatory notes/remarks in the balance sheet. The Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years should be shown under this head. Any adjustment from the Blocked Account should be permitted only with the authorization of two officials one of whom should be from outside the branch concerned, preferably from the Controlling/Head Office if the amount exceeds Rupees one lakh.

Notes – General

			(i)For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items. (ii)The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability. (iii)It is proposed to show only pure deposits under this head 'deposits' and hence all surplus provisions for bad and doubtful debts, contingency funds, secret reserves, etc. which are not netted off against the relative assets, should be brought under the head 'Others (including provisions)'. (iv) The amount of subordinated debt raised against Tier II capital should be indicated.
Cash and Balances with the Reserve Bank of India	6	**I.** Cash in hand (including foreign currency notes) **II.** Balances with Reserve Bank of India (i) in Current Account (ii) in other Accounts	Includes cash in hand including foreign currency notes and also of foreign branches in case of banks having such branches.
Balances with banks and money at call and short notices	7	**I. In India** (i) Balances with banks (a) in current accounts (b) in other Deposit accounts	Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.
		(ii) Money at call and short notice (a) with banks (b) with other institutions **II. Outside India**	Includes deposits repayable within 15 days or less than 15 days notice lent in the inter-bank call money market.

		(i) Current accounts	Includes balances held by foreign branches and balances held by Indian branches of the banks outside India.
		(ii) Deposits accounts	Balances held with foreign branches by other branches of the bank should not be shown under this head but should be included in inter-branch accounts. The amounts held in 'current accounts' and 'deposit accounts' should be shown separately.
		(iii) Money at call and short notice	Includes deposits usually classified in foreign countries as money at call and short notice.
Investments	8	**I. Investments in India**	
		(i) Government securities	Includes Central and State Government securities and Government treasury bills. These securities should be shown at the book value. However, the difference between the book value and market value should be given in the notes to the balance sheet.
		(ii) Other approved securities	Securities other than Government securities, which according to the Banking Regulation Act, 1949 are treated as approved securities, should be included here.
		(iii) Shares	Investments in debentures and bonds of companies and corporations not included in item (*ii*) should be included here.
		(iv) Debentures and Bonds	Investments in debentures and bonds of and corporations not included in item (*ii*) should be included here.
		(v) Investments in subsidiaries/joint ventures	Investments in subsidiaries/joint ventures (including RRBs) should be included here.
		(vi) Others	Includes residual investments, if any, like gold, commercial paper and other instruments in the nature of shares/debentures/bonds.
		II. Investments outside	

			India	
			(i) Government securities (including local authorities)	All foreign Government securities including securities issued by local authorities may be
			(ii) Subsidiary and/ or joint ventures abroad	All investments made in the share capital of subsidiaries floated outside India and/or joint ventures abroad should be classified under this head.
			(iii) Others	All other investments outside India may be shown under this head.
				Notes-General
				Indicate the gross value of investments in India and outside India, the aggregate of provisions for depreciation separately on investments in India and outside India, and the net value of investments in India and outside India, the total of which will be carried to balance sheet. The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.
Advances	9	**A.**	(i) Bills purchased and discounted (ii) Cash credits, over-drafts and loans repayable on demand	In classification under section 'A'. All out standings in India as well as outside less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.
			(iii) Term loans	Including overdue instalments.
		B.	(i) Secured by tangible assets (includes advances against book debts)	All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India
			(ii) Covered by Bank/	Advances in India and outside India to the

	Government Guarantee	extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC & ECGC are to be included.
	(iii) Unsecured	All advances not classified under (*i*) and (*ii*) will be included here. Total of 'A' should tally with the total of 'B'.
C.	**I.** Advances in India (i) Priority sectors (ii) Public sector (iii) Banks (iv) Others **II.** Advances outside India (i) Due from banks (ii) Due from others	Advances should be broadly classified into 'Advances in India, and 'Advances outside India'. Advances in India will be further classified on the sectoral basis as indicated. Advances on sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank are to be classified under the head 'Priority sector'. Such advances should be excluded from item (ii) *i.e.,* advances to public sector.
	(a) Bills purchased and discounted (b) Syndicate loans (c) Others	Advances to Central and State Governments and other Government undertaking including Government companies and corporations which are, according to the statutes,to be treated as public sector companies are to be included in the category "Public Sector". All advances to the banking sector including co-operative banks will come under the head 'Banks'. All the remaining advances will be included under the head 'Others' and typically this category will include non-priority advances to the private, joint and co-operative sectors. **Notes – General** (*i*) The gross amount of advances including refinance but excluding rediscounts provisions made to the satisfaction of auditors should be shown as advances.

			(*ii*) Term loans will be loans not repayable on demand. (*iii*) Consortium advances would be shown net of share from other participating banks/institutions.
Fixed Assets	10	**I.** Premises (i) At cost as on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Premises wholly or partly owned by the banking company for the purpose of business including residential premises should be shown (against 'Premises'. In the case of premises and other fixed assets, the previous balance, additions thereto and deductions there from during the year as also the total depreciation written off should be shown. Where sums have been written off on reduction of capital or revaluation of assets, every balance sheet after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of the revision made.
		II. Other Fixed Assets(including furniture and fixtures) (i) At cost on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Motor vehicles and other fixed assets other than premises but including furniture and fixtures should be shown under this head.
Other Assets	11	**I.** Inter-office adjustments (net)	The inter-office adjustments balance, if in debit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balances of inter-office

	adjustment accounts, all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown representing mostly items in transit and unadjusted items. In working out the net position, credit entries outstanding for more than five years in inter-branch accounts should be segregated and transferred to a separate Blocked Account. While arriving at the net amount of inter-branch transactions for inclusion under Schedule 5 or 11, as the case may be, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries.
II. Interest accrued	Interest accrued but not due on investments and advances and interest due but not collected on investments will be the main components of this item. As banks normally debit the borrowers' accounts with interest due on the balance sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised on the ordinary course should be shown under this head.
III. Tax paid in advance/tax deducted at source	The amount of tax deducted at source on securities, advance tax paid etc. to the extent that these items are not set off against relative tax provisions should be shown against this item.
IV. Stationery and stamps	Only exceptional items of expenditure on stationery like bulk purchase of securities paper, loose leaf or other ledgers, etc. which are shown as quasi-asset to be written off over a period of time should be shown here. The value should be on a realistic basis and cost escalation should not be taken into

			account, as these items are for internal use.
		V. Non-banking assets acquired in satisfaction of claims.	Immovable properties/tangible assets acquired in satisfaction of claims are to be shown under this head.
		VI. Others	This will include items like claims which have not been met, for instance, clearing items, debit items representing addition to asset or reduction in liabilities which have not been adjusted for technical reasons, want of particulars, etc., non-interest bearing loans and advances given to staff by a bank as employer and not as a banker, etc. Items which are in the nature of expenses which are pending adjustments should be provided for and the provision netted against this item so that only realisable value is shown under this head. Accrued income other than interest may also be included here. Outstanding in credit card operations should be shown as part of "advances" (Schedule instead of clubbing these under "Other Assets"
Contingent Liabilities	12	**I.** Claims against the bank not acknowledged as debts	
		II. Liability for partly paid investments	Liability on partly paid shares, debentures, etc. will be included under this head.
		III. Liability on account of outstanding forward exchange contracts	Outstanding forward exchange contracts may be included here.
		IV. Guarantees given on behalf of constituents (i) In India (ii) Outside India	Guarantees given for constituents in India and outside India may be shown separately.
		V. Acceptances endorsements and other	This item will include letters of credit and bills accepted by the bank on behalf of

		obligations	customers.
		VI. Other items for which the Bank is contingently liable	Arrears of cumulative dividends, bills rediscounted, commitments under under-writing contracts, estimated amounts of contracts remaining to be executed on capital account and not provided for, etc. are to be included here.
Bills for Collection			Bills and other items in the course of collection and not adjusted will be shown against this item in the summary version only. No separate schedule is proposed.
		Profit and Loss Account	
Interest earned	13	**I.** Interest/discount on advances/bills	Includes interest and discount on all types of loans and advances like cash credit, demand loans, overdraft, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue, interest and also interest subsidy, if any, relating to such advances/bills.
		II. Income on Investments	Includes all income derived from the investment portfolio by way of interest and dividend
		III. Interest on balances with Reserve Bank of India and other Interbank funds	Includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
		IV. Others	Includes any other interest/discount income not included in above heads.
Other Income	14	**I.** Commission, exch ange and brokerage	Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on letter of credit and guarantees, commission on Government business commission on

			other permitted agency business including consultancy and other services, brokerage, etc. on securities. It does not include foreign exchange income.
		II. Profit on sale of investments Less Loss on sale of investments	Includes profit/loss on sale of securities, furniture land and buildings, motor of vehicle, gold, silver etc.. Only the net position should be shown. If the net position is a loss, the amount should be shown as deduction.
		III. Profit on revaluation of investments Less: Loss on revaluation of investments	The net profit/loss on revaluation of assets may also be shown under this item.
		IV. Profit on sale of land, building and other assets Less : Loss on sale of land, buildings and other assets	
		V. Profit on exchange transactions Less : Loss on exchange transactions	Includes profit/loss on dealing in foreign exchange all income earned by way of foreign exchange commission and charges on foreign exchange, transactions excluding interest which will be shown under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.
		VI. Income earned by way of dividends etc. from subsidiaries, companiesand/or joint ventures abroad/in India	
		VII. Miscellaneous income	Includes recoveries from constituents for the godown rents, income from bank's properties, security charges, insurance etc. and any other miscellaneous income. In case any item under this head exceeds one percentage of the total income, particulars may be given in the notes.
Interest Expended	15	**I.** Interest on deposits	Includes interest paid on all types of deposits including deposits from banks

			and others institutions.
		II. Interest on Reserve Bank of India/inter-bank borrowings	Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.
		III. Others	Includes discount / interest on all borrowings/refinance from financial institutions. All otherpayments like interest on participation certificates, penal interest paid, etc. may also be included here.
Operating expenses	16	**I.** Payments to and Provisions for employees	Includes staff salaries / wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity liveries to staff, leave fare concessions, staff welfare, medical allowance to staff etc.
		II. Rent, taxes and lighting	Includes rent paid by the banks on building and other municipal and other taxes paid (excluding income tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear under the head 'Payments to and provisions for employees'.
		III. Printing and Stationery	Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.
		IV. Advertisement and publicity	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.
		V. Depreciation on Bank's property	Includes depreciation on bank's own property: motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non banking assets, etc.

VI. Directors' fees, allowances and expenses	Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowances, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of local Committee members may also be included under this head.
VII. Auditors' fees and expenses (including branch auditors' fees and expenses)	Includes fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services the expenses incurred in that context including fees may not be included under this head but shown under 'other expenditure'.
VIII. Law charges	All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
IX. Postage, telegrams, telephones, etc.	Includes all postal charges like stamps, tele-gram, telephones, teleprinter, etc.
X. Repairs and maintenance	Includes repairs to banks' property, their maintenance charges, etc..
XI. Insurance	Includes insurance charges on bank's property, insurance premium paid to Deposit Insurance & Credit Guarantee Corporation, etc. to the extent they are not recovered from the concerned parties.
XII. Other expenditure	All expenses other than those not included in any of the other heads like,

	licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. may be included under this head. In case any particular item under this head exceeds one percentage of the total income particulars may be given in the notes.
Provisions and contingencies	Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for diminution in the value of investments, transfers to contingencies and other similar items.
Treatment of accumulated losses	While preparing the Balance Sheet and Profit and Loss Account accumulated losses should be brought forward under Item III or Form "B" before appropriation of the balance profit made.

2.12 DISCLOSURE OF ACCOUNTING POLICIES

In order to bring the true financial position of banks to pointed focus and enable the users of financial statements to study and have a meaningful comparison of their positions, the banks should disclose the accounting policies regarding key areas of operation at one place along with notes on accounting in their financial statements - this is the content of a Circular No. DBOD. BP. BC. 91/C.686/91 dated 28-2-1991 of the Reserve Bank of India issued to the Chief Executives of all Scheduled Commercial Banks excluding Regional Rural Banks. RBI also issued a specimen form in which the accounting policies may be disclosed. The specimen indicates broadly the areas where the accounting policies followed by each bank should be disclosed and the banks can make necessary modifications to suit their individual needs. The specimen form is given below :

Specimen Form of Accounting Policies

I. Principal Accounting Policies

(**1**) **General** : The accompanying financial statements have been prepared on the historical cost basis and conform to the statutory provisions and practices prevailing in the country.

(**2**) **Transactions involving foreign exchange** - (a) Monetary assets and liabilities have been translated at the exchange rate prevailing at the close of the year. Non-monetary assets have been carried in the books at the historical cost.

(b) Income and expenditure items in respect of the Indian branches have been translated at the exchange rates ruling on the date of the transaction and in respect of overseas branches at the exchange rates prevailing at the close of the year.

(c) Profit or loss on pending forward contracts has been accounted for.

(**3**) **Investments** : (a) Investments in Government and other approved securities in India are valued at the lower of cost or market value.

(b) Investment in subsidiary companies and in some companies (*i.e.* companies in which at least 25% of the share capital) have been accounted for on the historical cost basis.

(c) All other investments are valued at the lower of cost or market value.

(**4**) **Advances** : (a) Provisions for doubtful advances have been made to the satisfaction of the auditors:

- (i) in respect of the identified advances, based on a periodical review of advances and after taking into account the portion of advance guaranteed by the Deposit Insurance and Credit Guarantee Corporation, the Export Credit and Guarantee Corporation and similar statutory bodies.
- (ii) in respect of general advances as a percentage of total advances taking into account guidelines issued by the Government of India and the Reserve Bank of India.

(b) Provisions in respect of doubtful advances have been deducted from advances to the extent necessary and the excess has been included under “Other liabilities and provisions”.

(c) Provisions have been made on a gross basis. Tax relief which will be available when the advance is written off will be accounted for in the year of write off.

(**5**) **Fixed Assets** : (*a*) Premises and other fixed assets have been accounted for at their historical cost. Premises which have been revalued are accounted for at the values determined on the basis of such revaluation made by professional valuers. Profit arising on revaluations has been credited to Capital Reserve.

(b) Depreciation has been provided for on the straight line/diminishing balance method.

(c) In respect of revalued assets, depreciation is provided for on the revalued figure and an amount equal to the additional depreciation consequent on revaluation is transferred annually from the Capital Reserve to the General Reserve/Profit and Loss Account.

(**6**) **Staff Benefits** : Provisions for gratuity/pension benefits to staff has been made on as accrual/cash basis. Separate funds for gratuity/pension have been created.

(**7**) **Net Profit** : (a) The net profit disclosed in the profit and loss account is after :

(i) provisions for taxes on income in accordance with statutory requirements.

(ii) provision for doubtful advances.

(iii) adjustments to the value of "current investments in Government and other approved securities in India valued at lower of cost or market value".

(iv) transfers to contingency funds.

(v) other usual or necessary provisions.

(b) Contingency funds have been grouped by the Balance Sheet under the head "Other Liabilities and Provisions."

SELF-EXAMINATION QUESTIONS

I. Objective Type Questions

1. Entries in the personal ledger is prepared from

   (a) Vouchers

   (b) Day book

   (c) Rough register

   (d) None of the above

2. The journal maintained by each department of the bank to note the transfer entries is known as

   (a) Primary book

   (b) Secondary book

   (c) Memorandum book

   (d) Day book

3. The main cash book of a bank is maintained by

   (a) Main cashier

   (b) Chief cashier

   (c) Petty cashier

   (d) A person other than the cashier

4. Every bank has to file their return to

   (a) Income tax department

(b) Reserve Bank of India

(c) Head office of their bank

(d) No need to file return

[**Answer 1**-(a), **2**-(c), **3**-(d), **4**-(b)]

II. Short Answer Type Questions

5. Explain Slip system of posting and double voucher system.

6. Describe any three characteristics of bank book keeping system

7. Briefly discuss the classification to be shown in the schedules relating to final accounts of a bank.

   (*i*) Deposits, (*ii*) Borrowings, (*iii*) Investments, (*iv*) Reserve and Surplus, (*v*) Other income, (*vi*) Operating expenses.

III. Long Answer Type Questions

8. Briefly explain the bank's system of book-keeping. Also give a list of books and registers maintained by a commercial bank.

9. Distinguish between principal books and subsidiary books of banks. State the purpose of principal and subsidiary books. How is control account balance in the principal book reconciled with individual ledger balance in the subsidiary books ?

10. Give a list of returns to be filed with the RBI by scheduled and non-scheduled commercial banks.

11. What are the principal aspects to be shown in the balance sheet and profit and loss account of a bank ?

IV. Practical Problem

12. A bank has 10,000 saving bank accounts. It maintains ten subsidiary ledgers each containing 100 accounts. On 12th Dec. 2005 it has been found on the basis of vouchers that there are 500 withdrawals and 600 deposits. Explain how the bank will account these transactions.

UNIT - 3 : CAPITAL ADEQUACY NORMS

3.1 INTRODUCTION

The Committee on Banking Regulations and Supervisory Practices (Basle Committee) in July 1988 released a framework on international convergence of capital measure and capital standards. The fundamental objectives that underly the committee's work on capital convergence are firstly, that the new framework shall serve to strengthen the soundness and stability of the banking system and, secondly, that the framework shall be fair and for a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competition in equality among the international banks. In view of the Basle Committee Report discussion is in progress in India also about the application of capital adequacy norms to the banks functioning in India.

In this Unit we shall discuss definitions of capital funds and minimum capital requirement, technique of computing weightage for the purpose of capital adequacy norm and the reporting format.

3.2 CAPITAL FRAMEWORK OF BANKS FUNCTIONING IN INDIA

In India, various groups of banks are at present subject to different minimum capital requirements as prescribed in the statutes under which they have been set-up and operate. The foreign banks operating in India should have foreign funds deployed in Indian business equivalent to 3.5% of their deposits as at the end of each year. Further there are prescriptions regarding maintenance of statutory reserves.

As per the new formula, every bank should maintain a minimum capital adequacy ratio based on capital funds and risk assets. As per the prudential norms, all Indian scheduled commercial banks (excluding regional rural banks) as well as foreign banks operating in India are required to maintain capital adequacy ratio (or capital to Risk Weighted Assets Ratio) which is specified by RBI from time to time. At present capital adequacy ratio is 9%.

The capital adequacy ratio is worked out as below :

$$\frac{\text{Capital fund}}{\text{Risk weighted assets and off balance sheet items}}$$

3.3 DEFINITION OF CAPITAL FUNDS

As per para 2.3.3 of Master Circular – Prudential Norms on Capital Adequacy – DBOD No. BP.BC. 4/21.01.002/2007 – 08 of RBI/2007 – 2008/26.

The Basle Committee has defined capital in two tiers - Tier-I and Tier-II. While Tier- I capital, otherwise known as core capital, provides the most permanent and readily available support to a bank against unexpected losses, Tier-II capital contains elements that are less permanent in nature or less readily available. Norms have been established by the RBI identifying Tier-I and Tier-II capital for Indian banks and foreign banks.

3.4 TIER-I AND TIER-II CAPITAL FOR INDIAN BANKS

Tier I capital (also known are core capital) provides the most permanent and readily available support to a bank against unexpected losses. Tier I capital comprises :

The aggregate of paid-up capital, statutory reserves; and other disclosed free reserves including share premium and capital reserves arising out of surplus on sale of assets

As reduced by :

equity investments in subsidiaries;

intangible assets;

current and brought forward losses.

Tier II capital comprises elements that are less permanent in nature or are less readily available than those comprising Tier I capital. The elements comprising Tier II capital are as follows :

(a) *Undisclosed reserves and cumulative perpetual preference assets* - These elements have the capacity to absorb unexpected losses and can be included in the capital, if they represent accumulations of post-tax profits and not encumbered by any known liability and should not be routinely used for absorbing normal loan or operating losses. Cumulative perpetual preference shares should be fully paid-up and should not contain clauses which permits redemption by the holder.

(b) *Revaluation reserves* - These reserves often serve as a cushion against unexpected losses but they are less permanent in nature and cannot be considered as core capital. Revaluation reserves arise from revaluation of assets that are under-valued on the bank's books. The extent to which the revaluation reserve can be relied upon as cushion for unexpected loss depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets. The subsequent proportion in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation etc. Therefore, it would be prudent to consider revaluation reserves at a discount of 55% (effective from 1st April, 1994) while determining their value for inclusion in Tier-II capital. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves.

(c) *General provisions and loss reserves* - If these are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, they can be included in Tier-II capital. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier-II capital. However, general provisions and loss reserves (including general provision on standard assets) may be taken only up to a maximum of 1.25 per cent of weighted risk assets.

(d) *Hybrid Debt Capital instruments* - In this category fall a number of capital instruments which combine certain characteristics of equity and certain characteristic of debt. Each has a particular feature which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier-II capital.

(e) *Subordinated Debt* - To be eligible for inclusion in the Tier-II capital the instrument should be fully paid up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the banks' supervisory authorities. They often carry a fixed maturity and as they approach maturity, they should be subjected to progressive discount for inclusion in Tier-II capital. Instrument with an initial maturity of less than five years or with a remaining maturity of one year should not be included as part of Tier-II capital. Subordinated debt instrument will be limited to 50% of Tier-I capital.

3.5 RATIO OF TIER II CAPITAL TO TIER I CAPITAL

The quantum of Tier II capital is limited to a maximum of 100% of Tier I Capital. This seeks to ensure that the capital funds of a bank predominantly comprise of core capital rather than items of a less permanent nature. It may be clarified that the Tier II capital of a bank can exceed its Tier I capital; however, in such a case, the excess will be ignored for the purpose of computing the capital adequacy ratio.

3.6 TIER I AND TIER II CAPITAL FOR FOREIGN BANKS

As in case of Indian banks, capital funds of foreign banks operating in India would also comprise of Tier I capital and Tier II capital.

Tier I capital of Foreign bank would comprise the following elements :

(i) Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

(ii) Statutory reserves kept in Indian books.

(iii) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

(iv) Capital reserve representing surplus arising out of sale of assets in India held in a separate account and which is not eligible for repatriation so long as the bank functions in India.

(v) Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.

(vi) The net credit balance, if any, in the inter-office account with Head Office/Overseas branches will not be reckoned as capital funds. However, any debit balance in Held Office Account will have to be set off against the capital.

Tier II Capital : The elements of Tier II capital of foreign banks are similar to those of Indian banks.

Risk-adjusted assets and off-balance sheet items constitute the denominator in the computation of capital adequacy ratio.

Risk-adjusted Assets

Various assets of a bank are exposed to varying degrees of risks. For example, cash balances are not susceptible to any risks whereas advances are susceptible to credit risks. Even within advances, the risk of loss arising from failure of the customer to settle his obligation fully is less in the case of loans guaranteed by DICGC/ECGC as compared to unguaranteed loans. Similarly, different off-balance sheet items also involve varying degree of risk. For example, the risk involved in guarantees given against counter-guarantees of other banks is much less compared to other guarantees. Similarly, guarantees related to particular transactions are less risky compared to general guarantees of indebtedness.

Recognising the above, the Reserve Bank has assigned different risk weights to different categories of assets. For example, cash, balances with Reserve Bank of India and other banks and several other assets have been assigned a risk weight zero, loan and advances have generally been assigned a risk weight of 100 per cent (except certain specified loans which have been assigned a risk weight of zero or lesser than 100 per cent considering the nature of security/guarantee against them). The risk adjusted value (with reference to which capital adequacy is to be assessed) of a category of assets is determined by multiplying the nominal value of the category as per the balance sheet with the risk weight assigned thereto. For example, if a bank has DICGC/ECGC guaranteed advances of Rs. 100 crores outstanding on the balance sheet date, the risk-adjusted value of these advances would be Rs. 50 crores (loans guaranteed by DICGC/ECGC have been assigned a risk weight of 50).

The following table shows the weights to be assigned to the value of different assets and off-balance sheet items.

A. Funded risk assets	Percentage weight
Cash in hand (including foreign currency notes)	0
Balances with Reserve Bank	0
Balances with banks (other than Reserve Bank of India)	20
Money at call and short notice	0
Investments [See Note 1 (b)]	
➢ Investments in government securities	2.5
➢ Investment in other approved securities guaranteed by the Central Government or a State Government	2.5
➢ Investment in other securities where payment of interest and repayment of principal are guaranteed by the Central Government or a State Government	2.5
➢ (However, in case of a default in interest/principal by the State Government concerned, the risk weight in respect of investments issued by the defaulting entities would be 100%.)	
➢ Investment in government guaranteed securities of government undertakings which do not form part of the approved market borrowing programme	20
➢ Investment in other approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Government	20
➢ Investment in bonds issued by other banks/public financial institutions	20
➢ Investment in securities which are guaranteed by banks or public financial institutions as to payment of interest and repayment of principal	20
➢ Claims on banks/public financial institutions (excluding bonds	20

issued for Tier II capital)	
➢ Investment in subordinated debt issued in the form of Tier II capital bonds by the other banks/public financial institutions	100
➢ Other investments	100
Loans and advances including bills purchased and discounted and other credit facilities (see Note 1) :	
➢ Loans guaranteed by Central Government	0
➢ Loans guaranteed by State Government	0
(However, in respect of cases where the guarantee has been invoked and the State Government concerned has remained in default, a risk weight of 20% on such advances should be assigned. Where State Governments continue to be in default in respect of such invoked guarantees after March 31, 2001, a risk weight of 100% should be assigned.)	
➢ Advances against terms deposits, life policies, NSCs, Indira Vikas Patras and Kisan Vikas Patras (where adequate margin is available)	0
➢ Loans to staff which are fully covered by supernannuation benefits and mortgage of flat / house.	20
(However, in respect of cases where loans to staff are not covered by superannuation benefits and mortgage of flat or house, a risk weight of 100% should be assigned.)	
➢ Loans guaranteed by DICGC/ECGC (limited to the amount guaranteed)	50
➢ Loans granted to public sector undertaking of Central Government/State Government	100
➢ Claims on other banks	20
➢ Take-out finance (see Note 2)	
Unconditional take-out finance where the	20

full credit risk is assumed by the taking over institution	
Unconditional take-out finance where only partial credit risk is assumed by the taking over institution	
➢ Amount to be taken over	20
➢ Amount not to be taken over	100
Conditional take-out finance	100
Others	100
Premises, furniture and fixtures	100
Other assets (except the following)	100
➢ Income-tax deducted at source (net of provision)	0
➢ Advance tax paid (net of provision)	0
➢ Interest due on government securities	0
➢ Accrued interest on CRR balances and claims on RBI on account of government transactions (net of claims of government/RBI on the bank on account of such transactions)	0

Notes :

1. In the case of loans and advances, the following amounts are deducted :
   (a) The amount of cash margin or deposit made against the advances as a collateral.
   (b) The amount of provision for bad and doubtful debts. (Similarly, in the case of other assets, e.g., investments, provision for depreciation are deducted.)
   (c) Credit balances in the current or other accounts of the borrower which are not earmarked for specific purpose and are free from any lien.
2. In respect of take-out finance, the 20 per cent risk weight will apply only if the taking-over institution is a bank or an all-India financial institution specified in this behalf by the Reserve Bank. If the counter-party risk is guaranteed by the Government, the risk weight will be zero.
3. The all-India financial institutions whose bonds/debentures would qualify for 20 per cent

risk weight for capital adequacy ratio are as the following.

(i) Industrial Credit and Investment Corporation of India Ltd.

(ii) Industrial Finance Corporation of India Ltd.

(iii) Industrial Development Bank of India.

(iv) Industrial Investment Bank of India Ltd.

(v) Tourism Finance Corporation of India Ltd.

(vi) Risk Capital and Technology Finance Corporation Ltd.

(vii) Technology Development and Information Company of India Ltd.

(viii) Power Finance Corporation Ltd.

(ix) National Housing Bank.

(x) Small Industrial Development Bank of India.

(xi) Rural Electrification Corporation Ltd.

(xii) Indian Railways Finance Corporation Ltd.

(xiii) National Bank for Agriculture and Rural Development

(xiv) Export-Import Bank of India.

(xv) Infrastructure Development Finance Co. Ltd.

(xvi) Housing and Urban Development Corporation Ltd.

(xvii) Indian Renewable Energy Development Agency Ltd.

4. Equity investments in subsidiaries, intangible assets and losses have to be deducted in computing Tier I capital.

Off-Balance Sheet Items

In the case of off-balance sheet items, the credit risk exposure has to be calculated by first multiplying the face amount of each of the off-balance sheet items (as reduced by any cash margins/deposits) by the 'credit conversion factor' and then multiplying the resultant figure by the 'risk weight' attributable to the relevant counter-party as indicated in the table below. While the credit conversion factors reflect the risk of loss inherent in the nature of the off-balance sheet item, the risk weight attributable to the relevant counter-party recognises the degree of likelihood of the counter-party making the default.

Off-balance sheet items	*Credit conversion factor (per cent)*	*Risk weight (per cent)*
Direct credit substitutes, e.g., general guarantees of indebtedness (including stand-by letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)		
➢ Guaranteed by Central Government /	100	0
➢ State Government		
➢ Counter-guaranteed by other banks	100	20
➢ Others	100	100
Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)		
➢ Guaranteed by Central Government /	50	0
➢ State Government		
➢ Counter-guaranteed by other banks	50	20
➢ Others	50	100
Short-term self-liquidating trade-related contingencies (such as documentary credits collateralised by the underlying shipments)		
➢ Guaranteed by Central Government / State Government	20	0
➢ Counter-guaranteed by other banks	20	20
➢ Others	20	100
Sale and repurchase agreements and assets sales with recourse, where the credit risk remains with the bank		

➢ Guaranteed by Central Government / State Government	100	0
➢ Counter-guaranteed by other banks	100	20
➢ Others	100	100
Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain draw down	100	100
Note issuance facilities and revolving under-writing facilities	50	100
Unconditional take-out finance where the bank is the taking-over institution	100	100
Conditional take-out finance where the bank is the taking-over institution		
➢ Where the counter-party risk is guaranteed by	50	0
➢ the Governments		
➢ Others	100	100
Other commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year		
➢ Guaranteed by Central Government / State Government	20	0
➢ Counter-guaranteed by other banks	20	20
➢ Others	20	100
Similar commitments with an original maturity up to one year, or which can be unconditionally canc-celled at any time	0	0
Aggregate outstanding foreign exchange contracts of original maturity –		

➢	up to 14 calendar days	2	0
➢	more than 15 calendar days but less	2	100
➢	than one year		
➢	for each additional year or part thereof	3	100

Foreign Exchange/Gold Open Positions

Besides meeting the prescribed minimum capital requirement in relation to risk-weighted assets and off-balance-sheet items, banks are also required to maintain Tier I capital to the extent of 5% of their foreign exchange open position limit and gold open position limit. For this purpose, the open positions in respect of foreign exchange as well as gold carry a risk weight of 100.

3.7 REPORTING FOR CAPITAL ADEQUACY NORMS

Banks should furnish an annual return commencing from the year ended 31st March, 1992 indicating (*a*) Capital funds, (*b*) conversion of off-Balance Sheet/non-funded exposures, (*c*) calculation of risk weighted assets, and (*d*) calculations of capital funds ratio. The format for the returns is given in the annexure. In the case of Indian banks having branches abroad, the break-up and aggregate in respect of domestic and overseas operations will have to be furnished. The returns should be signed by two officials who are authorised to sign the statutory returns now being submitted to the Reserve Bank.

Reporting format

Statement of capital funds, risk assets/exposures and risk assets ratio

Part A - Capital funds and risk assets ratio

(Amount in Rs. '000s omitted)

1. Capital funds

A. Tier I Capital elements

(i) Indian banks

(a) Paid-up capital

Less: 1. Equity investments in subsidiaries

2. Intangible assets and losses

Total

(b) Reserve and Surplus

1. Statutory Reserves

2. Share premium

3. Capital reserve (*see* note below)
4. Other disclosed reserves

   (to be specified)

   Total

   Total (a + b) = Tier I capital

Note : Capital reserve representing surplus on sale of assets and held in a separate account only will be included.

(ii) Foreign banks

(a) "Interest-free funds from Head Office" kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norm.

(b) Statutory reserves.

(c) Remittable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

(d) Capital reserves representing surplus arising out of sale of assets in India held in a separate account and which is not repatriable so long as the bank functions in India.

(e) Interest free funds remitted from abroad for the purpose of acquisition of property and held in a separate account in Indian books.

The net credit balance, if any, in the inter-office account with Head Office/branches will not be reckoned as capital funds. However, any debit balance in Head Office account will have to be set off against the capital. Similarly, revaluation reserves, general/floating provisions and specific provisions made for loan losses and other asset losses or diminution in the value of any assets will not be reckoned as capital funds.

B. Tier II capital elements

(a) Undisclosed reserves and cumulative perpetual preference shares.

(b) Revaluation reserves.

(c) General provisions and loss reserves.

(d) Hybrid debt capital instruments.

(e) Subordinated debts.

II. Risk assets

(a) Adjusted value of funded risk assets i.e., on Balance Sheet items (to tally with Part

'B').

(b) Adjusted value of non-funded and off-Balance items (to tally with Part 'C').

(c) Total risk-weighted assets (a + b).

III. Percentage of capital funds to risk-weighted assets [I. II(C)].

Part B - Weighted assets *i.e.*, on-Balance Sheet items

(Amount in Rs. '000s omitted)

	Book value	Risk weight	Adjusted value
1. Cash & bank balances			
(a) Cash in hand (including foreign currency notes)		0	0
(b) Balances with banks in India -			
(i) Balance with RBI			
(ii) Balance with banks			
1. Current account (in India and outside India)			
2. Other accounts (in India and outside India)			
II. Money at call and short notice		0	0
III. Investments			
(a) Government and other approved securities*		0	0
(b) Others (net of depreciation provided)		100	
IV. Advances**			
Loans and advances, bills purchased and discounted and other credit facilities			
(a) Claims guaranteed by Government of India		0	0
(b) Claims guaranteed by		0	0

		State Governments	
	(c)	Claims on public sector undertakings of Governments	100
	(d)	Others	100

Note: 1. Netting may be done only for advances collateralised by cash margins in deposits and in respect of assets where provisions for depreciation or bad and doubtful debts have been made.

2. Equity investments in subsidiaries, intangible assets and losses deducted from Tier I capital should be assigned zero weight.

V.	Premises (net of depreciation provided)	100
VI.	Furniture and fixture (net of depreciation provided)	100
VII.	Other assets (including branch adjustments, non-banking assets, etc.)	100
	Total	

*Provision, if any, made for depreciation in investments in Government and other approved securities may be included by way of a footnote.

**Provisions held, either general or specific, for bad and doubtful debts may be indicated by way of a foot note.

Part C - Weighted non-funded exposures/off Balance Sheet items

Each off-Balance Sheet item may be submitted in the format indicated below:

(Amount in Rs. '000s omitted)

Nature	Book of item value	Conversion value	Equivalent factors	Risk value	Adjusted weight

Note : Netting may be done only for advances collateralised by cash margins in deposits and in respect of assets where provisions for depreciation or for bad and doubtful debts have been made.

Illustration 1

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the risk-adjusted asset and risk weighted assets ratio -

Capital Funds:	(Figures in Rs. Lakhs)
Equity Share Capital	4,80,00
Statutory Reserve	2,80,00
Capital Reserve (of which Rs. 280 lakhs were due to revaluation of assets and the balance due to sale)	12,10
Assets:	
Cash Balance with RBI	4,80
Balances with other Bank	12,50
Certificate of Deposits with other Commercial Banks	28,50
Other Investments	782,50
Loans and Advances:	
(i) Guaranteed by government	128,20
(ii) Guaranteed by public sector undertakings of Government of India	702,10
(iii) Others	52,02,50
Premises, furniture and fixtures	182,00
Other Assets	201,20
Off-Balance Sheet Items:	
Acceptances, endorsements and letters of credit	37,02,50

Solution

		Rs. in lakhs	*Rs. in lakhs*
(i)	Capital Funds - Tier I :		
	Equity Share Capital		480,00
	Statutory Reserve		280,00
	Capital Reserve (arising out of sale of assets)		9,30

			769,30
Capital Funds - Tier II :			
Capital Reserve (arising out of revaluation of assets)		280	
Less : Discount to the extent of 55%		154	1,26
			770,56

(ii) Risk Adjusted Assets

Funded Risk Assets	Rs. in lakhs	Percentage weight	Amount Rs. in lakhs
Cash Balance with RBI	4,80	0	—
Balances with other Banks	12,50	0	—
Certificate of deposits	28,50	0	—
Other Investments	782,50	100	782,50
Loans and Advances:			
(i) guaranteed by government	128,20	0	—
(ii) guaranteed by public sector undertakings of Central Govt.	702,10	0	—
(iii) Others	52,02,50	100	52,02,50
Premises, furniture and fixtures	1,82,00	100	1,82,00
Other Assets	2,01,20	100	2,01,20
			63,68,20
Off-Balance Sheet Item	*Rs. in Lakhs*	*Credit Conversion Factor*	
Acceptances, Endorsements and Letters of credit	37,02,50	100	37,02,50
			100,70,70

Risk Weighted Assets Ratio: $\frac{\text{Capital Funds}}{\text{Risk Adjusted Assets}} \times 100$

$= \frac{770{,}56}{100{,}70{,}70} \times 100 = 7.65\%$

Expected ratio is 9%. So the bank has to improve the ratio.

SELF-EXAMINATION QUESTIONS

I. Objective Type Questions

1. Capital adequacy ratio is based on
   (a) Capital and debts of the bank
   (b) Capital funds and risk assets of the bank
   (c) Secured and unsecured assets of the bank
   (d) None of the above
2. Tier-I capital
   (a) provides the most permanent and readily available support to a bank against expected losses
   (b) contains elements that are less permanent in nature or less readily available.
   (c) Both (a) and (b)
   (d) None of the above
3. Tier-II capital
   (a) provides the most permanent and readily available support to a bank against expected losses
   (b) contains elements that are less permanent in nature or less readily available.
   (c) Both (a) and (b)
   (d) None of the above
4. Undisclosed Reserves is included in the
   (a) Tier-I capital
   (b) Tier-II capital
   (c) Both the capital
   (d) None of the above

   [**Answer 1**-(b), **2**-(a), **3**-(b), **4**-(b)]

II. Short Answer Type Questions

5. What is capital fund for the purpose of computing capital adequacy ratio for the Indian banks?

6. What is the ratio to be maintained by the Indian banks for Tier-I and Tier-II capital.

7. Explain briefly the need for fixing up capital adequacy norms for the banks

III. Long Answer Type Questions

8. What is Tier-I and Tier-II capital? Also give the items included under it.

9. Define risk adjusted assets and off-balance sheet items

IV. Practical Problems

10. Given below the details of capital funds, assets and off balance sheet items from which you are required to compute the risk asset ratio.

    Capital funds: Equity share capital Rs. 1,50,000, Statutory Reserve Rs. 2,75,000, Capital Reserve (created by the value of the fixed assets Rs. 2,00,000)

    Assets: Cash in hand Rs. 25,000, Cash with Reserve Bank Rs. 40,000, Certificate of deposit with other commercial banks Rs. 25,000.

    Advances Rs. 8,50,000, Investments Rs. 6,12,000, Premises, furniture and other fixed assets Rs. 1,80,000.

    Off-Balance Sheet Items:

Letter of credit	Rs. 5,00,000
Expenses	Rs. 4,00,000
Guarantees & other obligations	Rs. 4,00,000

UNIT – 4 : INCOME RECOGNITION, CLASSIFICATION OF ASSETS AND PROVISIONS

Learning Objectives

After studying this unit, you will be able to:

- Determine the profit/loss of a bank is determined by the income recognition policy. Learn the technique of income recognition followed by a bank.
- Classify advances of a Bank according to the riskiness i.e. standard assets, sub-standard assets, doubtful assets, and loss assets. Try to understand the definitions of various categories and also follow Illustration given in the chapter to learn.
- Create adequate provision against sub-standard, doubtful and loss assets. This helps to find out the bank profit in conservative manner. Reserve bank has issued guidelines stating the rates to be followed for making such provision. Learn the technique of creating provision on various categories of risk advances made by banks.
- Make provision for depreciation on their current investments. Learn how to classify investments into permanent and current and also follow the technique suggested by the Reserve Bank for computation of depreciation provision.

4.1 INCOME RECOGNITION

A Bank's advances are to be classified into performing assets and non-performing assets (NPA). The international practice is not to consider interest income from NPA on accrual basis but to consider such income as and when it is actually received.

An asset becomes non-performing when the bank does not receive income from it for a certain period. In concept, any credit facility (assets) becomes non-performing "when it ceases to generate income for a bank." The Reserve Bank of India has issued detailed guidelines to banks regarding the classification of advances between performing and non-performing assets which have been revised from time to time. The latest guidelines for determining the status of credit facilities are discussed below :

Term Loans

A term loan is treated as a non-performing asset (NPA) if interest and/or instalment of principal remains overdue for a period of more than 90 days.

Cash Credits and Overdrafts

A cash credit overdraft account is treated as NPA if it remains out of order for a period of more than 90 days. An account is treated as 'out of order' if ***any*** of the following conditions is satisified:

(a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power –

(b) Though the outstanding balance is less than the sanctioned limit/drawing power –

   (i) there are no credits continuously for more than 90 days as on the date of balance sheet; or

   (ii) credits during the aforesaid period are not enough to cover the interest debited during the same period.

(c) Further any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank.

Bills Purchased and Discounted

Bills purchased and discounted are treated as NPA if they remain overdue and unpaid for a period of more than 90 days.

Agricultural Advances

With effect from September 30, 2004, Advances granted for agriculture purposes becomes NPA if interest and/or instalment of principal remains overdue for two crop seasons in case of short duration crops and a loan granted for long duration crops will be treated ad NPA, if the instalment of principal or interest thereon remains overdue for one crop season

Crops having crop season of more than one year i.e. upto the period of harvesting the crops raised will be termed as 'long duration" crops and other crops will be treated as "short duration" crops.

The above NPA norms would also be made applicable to agricultural term loans availed by him.

In respect of other agricultural loans and term loans given to non agriculturists, identification of NPAs would be done on the basis as per non-agricultural advances which is at present 90 days delinquency norm.

Exempted Assets

Certain categories of advances have been exempted from being treated as non-performing for the purpose of income determination and/or provisioning, even though they meet the aforesaid criteria (*this aspect is discussed later in this chapter*).

Regularisation of Account by Year-end

The identification of NPA is to be done on the basis of the position as on the balance sheet date. If an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources (and not by sanction of additional facilities or transfer of funds between accounts), the account need not be treated as NPA. The bank should, however, ensure that the account remains in order subsequently. Also, a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for determining the status of the account as non-performing or otherwise.

Temporary Deficiencies

Banks have been advised that they may not classify a cash credit/overdraft account as NPA merely due to existence of some deficiencies which are of temporary nature such as non-availability of adequate drawing power, balance outstanding exceeding the limit, non-submission of stock statements, non-renewal of limits on the due date, etc.

Net Worth of Borrower/Guarantor or Availability of Security

Since income recognition is based on recoveries from an advance account, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security is not relevant for determining whether an account is NPA or not (this is, however, subject to certain exceptions discussion later in this chapter).

Determination of NPAs : Borrower-wise, Not Facility-wise

If any of the credit facilities granted to a borrower becomes non-performing, all the facilities granted to the borrower will have to be treated as NPA without any regard to performing status of other facilities.

Advances Under On-lending Arrangement

An exception to the above rule has been made in respect of agricultural advances as well as advances for other purposes granted by banks to ceded Primary Agricultural Credit Societies (PACSs) or Farmers Service Societies (FSSs) under the on-lending system. In such cases, only that particular credit facility granted to a PACS/FSS is to be classified as NPA which is in default for a period of –

(a) two harvest seasons not exceeding two half years in the case of agricultural advances; or

(b) more than 90 days in the case of other advances.

Other credit facilities granted to the PACS/FSS will not be treated as NPA. However, other direct loans and advances have been granted by the bank to the member borrower of a PACS/FSS outside the on-lending arrangement will become NPA if even one of the credit facilities granted to the borrower becomes NPA. Thus, above exemption does not extend to credit facilities granted outside the on-lending system.

Project Finance

In the case of bank finance given for industrial projects or for agricultural plantations etc. where moratorium is available for payment of interest, payment of interest becomes due after the moratorium or gestation period is over, and not on the date of debit of interest.

Advances guaranteed by Central Government of India and/or State Governments

Advances guaranteed by Central Government will become NPA only if the guarantee is invoked and repudiated. Accordingly, central government guaranteed advance even if become overdue should be classified as “standard asset”. However, the interest on such an advance is not to be taken to income account if it is not realised.

Advances Guaranteed by State Governments

If the overdue amount in state government guaranteed advances remains overdue for more than 90 days for the year ending 31.03.2006 the account will be identified as NPA. Now the condition of invocation of guarantee has been withdrawn for such advances.

Advances to Staff

As in the case of project finance, in respect of housing loans or similar advances granted to staff members where interest is payable after recovery of principal, the overdue status (in respect of payment of interest) should be reckoned from the date when there is default in payment of interest or repayment of instalment of principal on due date of payment.

Agricultural Advances affected by Natural Calamities

In terms of RBI instructions, where natural calamities impair the repayment capacity of agricultural borrowers, the bank can convert short-term production loan into term loan or reschedule the repayments, and sanction fresh short-term loan. In such cases, the term loan as well as fresh short-term loan may be treated as current dues and need not be classified as NPA. The asset classification of these loans would thereafter be done according to the guidelines. In other words, term loan as well as fresh short-term loan would be reckoned as having been granted for the first time.

Take-out Finance

In the case of take-out finance arrangement , the lending bank should apply the prudential norms in the usual manner so long as the account remains on its banks.

Take-out finance is a product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the institution/bank financing the infrastructure projects ('the lending institution') has an arrangement with a financial institution ('the taking-over instituion') for transferring to the latter the outstanding in respect of such financing on a pre-determined basis. There are several variants of take-out finance, but basically, they are either in the nature of unconditional take-out finance or conditional take-out finance. In the latter case, the taking-over institution stipulates certain conditions to be satisfied by the borrower before it is taken over from the lending instituion. Thus, in this variant of take-over arrangements, there is an inherent element of uncertainty over the ultimate transfer of the outstanding amount to the taking-over instituion. For a take-out finance arrangement to take effect, the borrower should also recognise the arrangement by way of inter-creditor arrangement.

Advances Guaranteed by EXIM Bank

In the case of advances covered under the guarantee-cum-refinance programme of EXIM Bank, to the extent payment has been received by the bank from the EXIM Bank, the advance may not be treated as NPA. The balance should, however, be treated as NPA. (if the conditions for treating it as NPA are satisfied).

Consortium Advances

In respect of consortium advances, each bank may classify the borrowal accounts according to its own record of recovery and other aspects having a bearing on the recoverability of the advances.

Income Recognition

Banks recognise income (such as interest, fees and commission) on accrual basis, i.e., as it is earned. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. In view of the significant uncertainty regarding ultimate collection of income arising in respect of non-performing assets, the guidelines require that banks should not take to income interest on non-performing assets until it is actually realised. When a credit facility is classified as non-performing for the first time, interest accrued and credited to the income account in the previous year which has not been realised should be reversed or provided for.

If interest income from assets in respect of a borrower becomes subject to non-accrual, fees, commission and similar income with respect to the same borrower that have been accrued should cease to accrue in the current period and should be reversed or provided for with respect to previous year if uncollected.

Advances Secured Against Certain Instruments

Advances secured against term deposits, national savings certificates (NSCs) eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and life insurance policies have been exempted from the above guidelines. Thus, interest on such advances may be taken to income account on due dates provided adequate margin is available in the respective accounts.

Take-out Finance

In the case of take-out finance, if based on record of recovery, the account is classified by the lending bank as NPA, it should not recognise income unless realised from the borrower/taking-over institution (if the agreement so provides).

Partial Recoveries in NPAs

Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credits facilities sanctioned to borrowers concerned.

Illustration 1

Given below interest on advances of a commercial bank (*Rs. in lakhs*)

	Performing assets		NPA	
	Interest earned	Interest received	Interest earned	Interest received
Term Loans	120	80	75	5
Cash credits and overdrafts	750	620	150	12
Bills purchased and discounted	150	150	100	20

Find out the income to be recognised for the year ended 31st March, 2008.

Solution

Interest on performing assets should be reconised on accrual basis, but interest on NPA should be recognised on cash basis.

	Rs. in lakhs
Interest on Term Loan :	(120 + 5) = 125
Interest on cash credits and overdraft :	(750 + 12) = 762
Income from bills purchased and discounted :	(150 + 20) = 170
	1,057

4.2 CLASSIFICATION OF BANK ADVANCES ON THE BASIS OF ASSET PERFORMANCE FOR DETERMINING LOSS PROVISIONS

The banks have to classify their advances into four broad groups (*i*) standard assets, (*ii*) sub-standard assets, (*iii*) doubtful assets and (*iv*) loss assets. Broadly speaking, classification of assets into the above categories should be done taking into account the degree of well defined credit weaknesses and extent of dependence on collateral security for realisation of dues. Banks should, therefore, keep the following definitions in mind while classifying the assets.

(i) **Standard Assets** - Standard asset is one which does not disclose any problems and which does not carry more than normal risk attached to the business. Such an asset is not a NPA as discussed earlier.

(ii) **Sub-standard Assets** - Sub-standard asset is one which has been classified as NPA for a period not exceeding 12 months. In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full. In other words, such an asset will have well-defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the bank will sustain some loss, if deficiencies are not corrected. In the case of term loans, those where instalments of principal are overdue for period exceeding one year should be treated as sub-standard. An asset where the terms of the loan agreement regarding interest and principal have been renegotiated or rescheduled after commencement of production, should be classified as sub-standard and should remain in such category for at least two years of satisfactory performance under the renegotiated or rescheduled terms. In other words, the classification of an asset should not be upgraded merely as a result of rescheduling, unless there is satisfactory compliance of the above condition.

(iii) **Doubtful Assets** - A doubtful asset is one which has remained NPA for a period exceeding 18 months. In the case of term loans, those where instalments of principal have remained overdue for a period exceeding 18 months should be treated as doubtful. Here too, as in the case of sub-standard assets, rescheduling does not entitle a bank to upgrade the quality of an advance automatically.

A loan classified as doubtful has all the weaknesses inherent in that classified as sub-standard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

(iv) **Loss Assets** - A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off, wholly or partly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bank asset is not warranted although there may be some salvage or recovery value.

It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances and not for the purpose of presentation of advances in the balance sheet. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

Threats to Recovery

As per the guidelines, upon becoming NPA, a credit facility would be classified first as sub-standard for a period not exceeding 12 months and then as doubtful. It has been clarified, however, that in respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to clarify them first as sub-standard and thereafter as doubtful. Banks have been advised to classify such accounts straightway as doubtful or loss assets, as appropriate irrespective of the period for which the account has remained NPA.

Security having Significant Realisable Value

It has been clarified that where the realisable value of security is significant, the credit facility should not be treated as loss assets. To illustrate, suppose, as on March 31, 2006, the bank or the internal/external auditor or the RBI inspection identifies a particular credit facility as a loss asset where the amount outstanding is Rs. 1.00 lakh and the salvage value of the security is Rs. 0.01 lakh. In such a case, the facility should be treated as a loss asset and provision should be made for Rs. 1.00 lakh (and not Rs. 0.99 lakh). If, on the other hand, the realisable value of the security is Rs. 0.80 lakh and the bank or the internal or external auditor or the RBI inspection has not treated the security as unrealisable, the credit facility should be treated as doubtful and not as a loss asset.

Renegotiation or Reschedulement After Commencement of Commercial Production

A credit facility where the terms of the loan agreement regarding interest and principal have been renegotiated or scheduled after commencement of commercial production should be classified as sub-standard and should remain in such category for at least one year of satisfactory performance under the renegotiated or rescheduled term (subject to the exception discussed in paragraph below. If such a facility was earlier classified as doubtful, it should similarly, continue to be classified in that category. In other words, the classification of a credit facility should not be upgraded merely as a result of rescheduling or renegotiation.

In some cases, the borrowal unit may have commenced production but the level and volume of production reached immediately after the date of completion of the project may not be adequate to generate the required cash flow to service the loan. Some lead time may be needed to achieve regular commercial production. In such cases, if in the opinion of the bank, the bottleneck in achieving regular commercial production is of a temporary nature and not indicative of any long-term impairment of the unit's economic viability and it is likely to achieve cash break-even if some time is allowed, the bank may reschedule the loan and treat the asset as standard. While the Board of Directors of each bank may lay down broad parameters for rescheduling in such cases, the lead time should normally not exceed one year from the schedule of commencement of commercial production as indicated in the terms of sanction. In respect of credit facilities sanctioned under consortium arrangements, the decision as to whether the borrowal unit has achieved regular commercial production and whether there is a need for rescheduling may be taken by the lead institution/lead bank, and the other participating institutions/banks may follow the same.

4.3 PROVISIONS

Taking into account the time lag between an account becoming doubtful of recovery, its recognition as such, the realisation of the security and the erosion over time in the value of security charged to the banks, it has been decided that banks should make provision against sub-standard assets, doubtful assets and loss assets on the following basis:

(a) *Loss assets* : The entire amount should be written off or full provision should be made for the amount outstanding.

(b) *Doubtful assets* : (*i*) Full provision to the extent of the unsecured portion should be made. In doing so, the realisable value of the security available to the bank should be determined on a realistic basis. DICGC/ECGC cover is also taken into account (this aspect is discussed later in this chapter). In case the advance covered by CGTSI guarantee becomes non-performing, no provision need be made towards the guaranteed portion. The amount outstanding in excess of the guaranteed portion should be provided for as per the extant guidelines on provisioning for non-performing advances.

(ii) Additionally, 20% - 100% of the secured portion should be provided for, depending upon the period for which the advance has been considered as a doubtful asset, as follows:

Period for which the advance has been considered as doubtful	% of provision on secured portion
Upto 1 year	20%
More than 1 year and upto 3 years	30%
More than three years	50%
i. Outstanding stock of NPA's as on 31.03.2004	60% w.e.f. 31.03.2005
	75% w.e.f. 31.03.2006
	100% w.e.f. 31.03.2007
ii. Advances classified as doubtful for more than three years on or after 01.04.2004	100% w.e.f. 31.03.2005

Illustration 2 *(Existing stock of advances classified as 'doubtful more than 3 years' as on 31 March, 2004.)*

The outstanding amount as on 31st March, 2004: Rs.25,000.

Realisable value of security: Rs.20,000.

Period for which the advance has remained in 'doubtful' category as on 31st March, 2004: 4 years (i.e., Doubtful more than 3 years)

Solution:

Provisioning requirement:

As on….	Provisions on secured portion		Provisions on unsecured portion		Total (Rs.)
	Rate (in %)	Amount	Rate (in %)	Amount	
31 March 2004	50	10,000	100	5,000	15,000
31 March 2005	60	12,000	100	5,000	17,000
31 March 2006	75	15,000	100	5,000	20,000
31 March 2007	100	20,000	100	5,000	25,000

Illustration 3 *(Advances classified as 'doubtful more than three years' on or after 1 April, 2006.)*

The outstanding amount (funded as well as unfunded) as on 31st March, 2006: Rs.10,000

Realisable value of security: Rs.8,000

Period for which the advance has remained in 'doubtful' category as on 31st March, 2006: 2.5 years.

Solution:

Provisioning requirement:

As on…	Asset Classification	Provisions on secured portion		Provisions on unsecured portion		Total (Rs.)
		%	Amount	%	Amount	
31 March, 2006	Doubtful 1 to 3 years	30	2,400	100	2,000	4,400
31 March, 2007	Doubtful more than 3 years	100	8,000	100	2,000	10,000

(iii) Banks are permitted to phase the additional provisioning consequent upon the reduction in the transition period from substandard to doubtful asset from 18 to 12 months over a four year period commencing from the year ending March 31, 2007, with a minimum of 20% each year.

(c) *Sub-standard assets* : A general provision of 10% on total outstanding should be made without making any allowance for DICGC/ECGC cover and securities available. An additional provision of 10% (i.e., total 20% of total outstanding) is required to be made on 'unsecured exposure' *ab initio* sanction of loan. Generally such a situation may arise in case of personal and education loans etc. Unsecured exposure is defined as 'an exposure where the realizable value of security is not more than 10% of the outstanding exposure (fund based and non-fund based). Security should not include guarantees, comfort letters etc

(d) *Standard assets* : A general provision of a minimum of 0.40% of total standard assets should be made. It has been clarified that the provision should be made on global laon portfolio basis and not on domestic advances alone.

Provision for Certain Specific Types of Advances

The guidelines also deal with provisioning for certain specific types of advances as follows :

Advances Secured Against Term Deposits, National Savings Certificates, Surrender Value of Life Policies, etc.

Advances secured against term deposits, NSCs eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and life insurance policies are exempted from provisioning requirements. Accordingly, the banks need not treat such accounts as NPAs. It may be noted that advances against gold ornaments, government securities, and all other kinds of securities are not exempted from provisioning requirements.

Advances Guaranteed by Government of India and/or State Governments

According to the guidelines, credit facilities where government guarantees are available, although overdue, should not be treated as NPA. However, it needs to be noted that such exemption from classification of advances as NPA is only for the purposes of assets classification and provisioning norms and not for the purposes of recognition of income. In other words, if such a credit facility meets the criteria for being classified as NPA, income in respect of the facility should not be recognised until it is actually realised. Also, in the case of state government guarantees, this exemption is available only where the guarantees have not been invoked. The State Government guaranteed accounts which have been invoked upon becoming NPA are to be treated at par with other advances for purpose of asset classification, income recognition and provisioning norms. Advances Under Rehabilitation Packages

Where additional facilities are granted to a unit under rehabilitation packages approved by the Board for Industrial and Financial Reconstruction (BIFR) or by term-lending institutions or the bank (on its own or under a consortium arrangement), provision should continue to be made for the dues in respect of existing credit facilities. As regards the additional facilities, provision need not to be made for a period of one year from the date of disbursement in respect of additional facilities sanctioned under rehabilitation packages approved by BIFR/term-lending institutions. Similarly, no provision need be made for a period of one year in respect of additional facilities granted to a sick small-scale industrial unit in accordance with a rehabilitation package/nursing programme drawn up by the bank itself or under a consortium arrangement. After the period of one year, the bank in consultation with its auditors would take a view whether there is need for making provision in respect of the additional facilities sanctioned.

Take-out Finance

In the case of take-out finance, if based on record of recovery, the account is classified by their lending bank as NPA, it should make provision for loan losses as per the guidelines. The provision should be reversed when the account is taken over by the taking-over institution. On taking over the account, the taking-over institution should make provisions as per the guidelines. For this purpose, the account should be considered to have become NPA from the actual date of its becoming so, even though the account was not on the books of the taking-over institution on that date.

4.3.1 Provisioning in advances covered by the guarantees of DICGC/ECGC : In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC) or by Deposit Insurance and Credit Guarantee Corporation (DICGC), provision is required to be made only for the balance in excess of the amount guaranteed by these corporations. In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realisable value of the security should be deducted from the outstanding balance before the ECGC/DICGC guarantee is off-set. The Reserve Bank of India has also clarified that if the banks are following more stringent method of provisioning in respect of advances guaranteed by ECGC/DICGC, such banks may continue to do so.

The manner of determining the amount of provision in respect of ECGC/DICGC guaranteed advances in accordance with the above guidelines is illustrated below. (It may be noted that these illustrations are merely intended to facilitate understanding of the RBI guidelines; they have not been issued by the RBI.)

Illustration 4

Outstanding Balance	Rs.4 lakhs
ECGC Cover	50%
Period for which the advance has remained doubtful	More than 3 years remained doubtful (as on March 31, 2006)
Value of security held (excludes worth of Rs.)	Rs.1.50 lakhs

Solution:

Provision required to be made:

Outstanding balance	Rs.4.00 lakhs
Less: Value of security held	Rs.1.50 lakhs
Unrealised balance	Rs.2.50 lakhs
Less: ECGC Cover (50% of unrealizable balance)	Rs.1.25 lakhs.
Net unsecured balance	Rs.1.25 lakhs
Provision for unsecured portion of advance	Rs.1.25 lakhs (@ 100% of unsecured portion)
Provision for secured portion of advance (as on March 31, 2008)	Rs.1.125 lakhs (@ 75% of the secured portion)
Total provision to be made	Rs.2.15 lakhs (as on March 31, 2008)

Illustration 5

Rajatapeeta Bank Ltd. had extended the following credit lines to a Small Scale Industry, which had not paid any Interest since March, 2002

	Term Loan	*Export Loan*
Balance Outstanding on 31.03.2006	Rs. 35 lakhs	Rs. 30 lakhs
DICGC/ECGC cover	40%	50%
Securities held	Rs. 15 lakhs	Rs. 10 lakhs
Realisable value of Securities	Rs. 10 lakhs	Rs. 08 lakhs

Compute necessary provisions to be made for the year ended 31st March, 2006.

Solution

	Term loan Rs. in lakhs	*Export credit Rs. in lakhs*
Balance outstanding on 31.3.2006	35.0	30.0
Less: Realisable value of Securities	10.0	8.0
	25.0	22.0
Less: DICGC cover @ 40%	10.0	
ECGC cover @ 50%	___	11.0
Unsecured balance	15.0	11.0

Required Provision:

100% for unsecured portion	15.00	11.00
Add: 100% for secured portion	10.00	8.00
Total provision required	25.00	19.00

Illustration 6

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of a commercial bank.

		Rs. in lakhs
Assets		
Standard		5000
Sub-standard		4000
Doubtful	: for one year	800
	: for three years	600
	: for more than three years	200
Loss Assets		1000

Solution :

Computation of provisions

Assets	**Amount Rs. in lakhs**	**% of provision**	**Provision Rs. in lakhs**
Standard	50,00	0.4	20
Substandard	40,00	10	400
Doubtful for one year	8,00	20	160
Doubtful for three years	6,00	30	180
Doubtful for more than three years	2,00	100	200
Loss	10,00	100	1,000
			1,960

This advance is classified as doubtful for more than 3 years on or after 01.04.2004

It is assumed that the advance has been classified as doubtful for more than 3 years or on or after 1.4.2004.

Illustration 7

From the following information find out the amount of provisions to be shown in the Profit and Loss Account of a Commercial Bank:

Assets	Rs. (in lakhs)
Standard	4,000
Sub-standard	2,000
Doubtful upto one year	900
Doubtful upto three years	400
Doubtful more than three years	300
Loss Assets	500

Solution

Computation of provision:

Assets	*Amount* (*Rs. in lakhs*)	*% of Provision*	*Provision* (*Rs. in lakhs*)
Standard	4,000	0.40	16
Sub-standard	2,000	10	200
Doubtful upto one year**	900	20	180
Doubtful upto three years**	400	30	120
Doubtful more than three years**	300	100	300
Loss	500	100	500
			1,316

** Doubtful assets are taken as fully secured.

4.4 CLASSIFICATION OF INVESTMENTS

A unique feature of investments of a bank is that a large proportion of the investments is made in pursuance of the requirement to maintain a certain minimum level of liquid assets. The directions issued by RBI from time to time affect the methods of classification of investments. The investment portfolio of a bank would normally consist of both approved securities (predominantly government securities) and other securities (shares, debentures, bonds etc.). Banks are required to classify their entire investment portfolio into three categories : held-to-

It is assumed that the advance has been classified as doubtful for more than 3 years or on or after 1.4.2004.

maturity, available-for-sale and held-for-maturity. Securities acquired by banks with the intention to hold them upto maturity should be classified as 'held-to-maturity'. Securities acquired by banks with the intention to trade by taking advantage of short-term price/interest rate movements should be classified as 'held-for-trading'. Securities which do not fall within the above two categories should be classified as 'available-for-sale'. Investments under 'held-to-maturity' category should not exceed 25 per cent of the total investments of the bank though a bank can at its discretion hold less than the aforesaid percentage under this category. Certain securities specified in this behalf are not to be reckoned while applying the ceiling of 25 per cent in respect of 'held-to-maturity' securities.

4.5 VALUATION OF INVESTMENTS

Over the years, the RBI has issued a number of circulars on valuation of investments by banks. Many of these circulars are no longer relevant as they have been superseded by subsequent circulars. The Banks are required to classify investments into three categories : held-to-maturity, available-for-sale and held-for-trading. (It may be noted that this classification is only for the purpose of valuation of investments. In the Balance Sheet, investments are required to be disclosed as per the third schedule to Banking Regulation Act, 1949 which prescribe an altogether different classification. (given in unit 1). The circular also lays down guidelines to be followed in case a bank desires to shift certain investments from one category to another.

RBI guidelines require every bank to formulate an 'Investment policy' with the approval of its Board of Directors to take care of the requirements relating to classification, shifting and valuation of investments as per the guidelines. Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the remaining to maturity. Any diminution in the value of investments in subsidiaries/joint ventures included under held-to-maturity category should be provided for if such diminution is other than temporary in nature. Such diminution should be determined and provided for each investment individually.

The individual scrips in the available-for-sale category should be marked to market at the year end or at more frequent intervals. While the net depreciation under each of the categories (required by third schedule to Banking Regulation Act, 1949 – refer Unit 1) should be recognised and fully provided for, the net appreciation under any of the aforesaid categories above should be ignored. Thus, banks can offset gains in respect of some investments marked-to-market within a category against losses in respect of other investments marked-to-market in that category. The guidelines however, do not permit offsetting of gains and losses across different categories. The book value of the individual securities would not have undergone any change after the revaluation. In other words, the depreciation or appreciation in value of individual scrips in accordance with the above methodology would not be credited to individual scrip accounts but would be held collectively in a separate account.

The individual scrips in the 'held-for-trading' category should be revalued at monthly or at more frequent intervals and net appreciation/depreciation of scrips under each of the categories in which investments are presented in the balance sheet should be required in the profit and loss account. The book value of the individual scrips should be changed to reflect the marked-to-market valuations.

Banks are required to follow AS 13 'Accounting for Investments' issued by the ICAI relating to long-term investments for valuation of investments in subsidiaries. In terms of AS 13, long term investments should be arrived in the financial statements at carrying cost. However, provision for diminution shall be made to recognise a decline other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

SELF-EXAMINATION QUESTIONS

Choose the most appropriate answer from the given options:

I. Objective Type Questions

1. What percentage of provision is required on performing assets?
   - (a) 10
   - (b) 40
   - (c) 0.40
   - (d) 25.
2. The Balance Sheet of Alpha Banking Co. has doubtful advances amounting Rs. 300 lakhs (classified as outstanding for more than three years on 31.03.2005). The provision will be made for Rs.
   - (a) 100.
   - (b) 300.
   - (c) 90.
   - (d) 120.
3. What will be the amount of provision to be shown in Profit and Loss Account of Dena Bank Ltd. in respect of doubtful asset aging 1 – 3 years of Rs. 1,000?
   - (a) 200.
   - (b) 300.
   - (c) 500.

(d) 100.

4. When income is to be recognized on cash basis by Safe Trust Bank, a distinction should be made between

   (a) Banking and Non-banking assets.

   (b) Monetary and Non-banking assets.

   (c) Current and Non-current assets.

   (d) Performing and Non-performing assets.

5. For the year ended 31st March, 2006 non-performing assets classified as sub-standard in Centura Bank Ltd. will be classified as doubtful after

   (a) 24 months.

   (b) 18 months.

   (c) 12 months.

   (d) 180 days.

   [Answer: 1-(c); **2**-(b); **3**-(b); **4**-(d); **5**-(c)]

II. Short Answer Type Questions

6. Define the following assets:

   (a) Standard assets

   (b) Sub-standard assets

   (c) Doubtful assets

   (d) Loss assets.

III. Long Answer Type Questions

7. What are non-performing assets? Discuss the accounting policy to be followed regarding recognition of income in relation to non-performing assets.

8. State the guidelines given by the Reserve Bank of India regarding making of provisions on different categories of bank advances.

IV. Practical Problems

9. From the following information find out the amount of provisions required to be made in the Profit & Loss Account of a commercial bank for the year ended 31st March, 2005 :

   (i) Packing credit outstanding from Food Processors Rs. 60 lakhs against which the bank holds securities worth Rs. 15 lakhs. 40% of the above advance is covered by ECGC. The above advance has remained doubtful for more than 3 years.

(ii) Other advances :

Assets classification	Rs. in lakhs
Standard	3,000
Sub-standard	2,200
Doubtful:	
For one year	900
For two years	600
For three years	400
For more than 3 years	300
Loss assets	600

UNIT - 5 : SOME SPECIAL TRANSACTIONS OF BANKS

Learning objectives

Learn the concept of a rebate on bills discounted. Try to understand the technique of computing such rebate.

Understand the technique for considering acceptance and endorsement as assets as well as liability.

Learn the meaning of cash reserve ratio. Also understand the technique of computing cash reserve ratio and incremental cash reserve ratio applicable to the scheduled commercial banks.

5.1 FUNCTIONS OF A COMMERCIAL BANK

Some of the main functions of modern commercial banks are:

(a) Receiving of money on deposit and providing facilities to constituents for payments by cheque,

(b) Dealing in securities on its own account and on account of customers,

(c) Lending of money by -

  (i) making loans and advances, and

  (ii) purchasing or discounting of bills,

(*d*) Transferring money from place to place by -

  (i) the issue of demand drafts, telegraphic transfers, traveller's cheques, etc.,

  (ii) collection of bills,

(e) Issuing letters of credit,

(f) Safe custody of securities and valuables,

(g) Issuing guarantees,

(h) Acting as executors and trustees sometimes through subsidiary companies formed for that purpose,

(i) Buying, selling and dealing in foreign exchange,

(j) Acting as managers for issue of capital by companies and performing functions incidental thereto.

5.2 DISCOUNTING AND COLLECTION OF BILLS

Among the various functions carried out by a bank, the two important ones are those relating to discounting of bills and acceptance and endorsement of bills on behalf of customers.

A bank may either straightaway purchase a bill or any other credit instrument from a customer or may collect it on his behalf. If it purchases or discounts the bill the amount would be immediately credited to the account of the customer less discount charge, and debited to Discounted Bills Account. This account is an asset. If, on the other hand, a bill is to be collected for a customer, the particulars of the bill would be recorded in a special book known as "Bills for Collection Register." Any book entry would not be required until the bill is collected. On collection, cash will be debited with the full amount received and the customer's account will be credited after deducting the amount of the commission. Bills held for collection are to be shown by way of note below the Balance Sheet as per requirement of the new forms.

5.2.1 Rebate on bills discounted - When a bank discounts a bill of exchange, the full amount of the discount earned is credited to the Discount Account but some of the bills discounted may not mature for payment by the close of the year; as a result, the amount of discount in respect of such bills would not have been earned during the year. On this consideration, the unexpired portion of such discount is carried forward by debiting the Discount Account and crediting Rebate on Bills Discounted Account. The latter account is shown on the liabilities side of the Balance Sheet as income received which had not accrued before the close of the year. At the commencement of the period next following, the account is closed off by transfer to the Discount Account.

Illustration 1

From the following details prepare "Acceptances, Endorsements and other Obligation A/c" as would appear in the general ledger.

On 1.4.2007 Acceptances not yet satisfied stood at Rs. 22,30,000. Out of which Rs. 20 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register revealed the following :

Client	Acceptances/Guarantees Rs.	Remarks
A	10,00,000	Bank honoured on 10.6.07
B	12,00,000	Party paid off on 30.9.07
C	5,00,000	Party failed to pay and bank had to honour on 30.11.07
D	8,00,000	Not satisfied upto 31.3.08

E	5,00,000	-do-
F	2,70,000	-do-
Total	42,70,000	

Solution

Acceptances, Endorsements and other Obligation Account

(in general ledger)

Dr.		*Rs. '000*				*Cr.* *Rs. '000*
2007-08	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	20,00	1.4.07	By Balance b/d		22,30
	To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank Rs. 22.30 lakhs less Rs. 20 lakhs)	2,30	2007-08	By Constituents' liabilities for acceptances/guarantees etc.		
				A	10,00	
				B	12,00	
				C	5,00	
10.6.07	To Constituents' liabilities for acceptances/guarantees etc. (Honoured by bank)	10,00		D	8,00	
				E	5,00	
				F	2,70	42,70
30.9.07	To Constituents' liabilities for acceptances/guarantees etc. (Paid off by party)	12,00				
30.11.07	To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank on party's failure to pay)	5,00				
31.3.08	To Balance c/d (Acceptances not yet satisfied)	15,70				
		65,00				65,00

Illustration 2

The following is an extract from Trial Balance of overseas Bank Ltd. as at 31st March, 2008

	Rs.	*Rs.*
Bills discounted	12,64,000	
Rebate on bills discounted not due		
on March 31st, 2007		22,160
Discount received		1,05,708

An analysis of the bills discounted is as follows:

	Amount *Rs.*	*Due Date 2008*	*Rate of Discount* *(%)*
(i)	1,40,000	June 5	14
(ii)	4,36,000	June 12	14
(iii)	2,82,000	June 25	14
(iv)	4,06,000	July 6	16

Calculate Rebate on Bills Discounted as on 31-3-2008 and show necessary journal entries.

Solution

In order to determine the amount to be credited to the Profit and Loss A/c it is necessary to first ascertain the amount attributable to the unexpired portion of the period of the respective bills. The workings are as given below :

(i) The bill is due on 5th June; hence the number of days after March 31st, is 66. The discount on Rs. 1,40,000 for 66 days @ 14% per annum will be

$14/100 \times 66/365 \times$ Rs. 1,40,000 = Rs. 3,544.

(ii) Number of days in the unexpired portion of the bill is 73: discount on Rs. 4,36,000 for 73 days @ 14% per annum will be Rs. 12,208.

(iii) Number of days in the unexpired portion of the period of the bill is 86: discount on Rs. 2,82,000 for 86 days @ 14% per annum will be Rs. 9,302.

(iv) Number of days in the unexpired portion of the period of the bill is 97: discount on Rs. 4,06,000 for 97 days @ 16 % p.a. will be Rs. 17,263.

The amount of discount to be credited to the Profit and Loss Account will be:

	Rs.
Transfer from Rebate on bills	
discount as on 31-3-2007	22,160
Add: Discount received during	
the year ended 31-3-2008	1,05,708
	1,27,868
Less: Rebate on bills discounted	
as on 31.3.2008 (see above)	42,317
	85,551

The journal entries will be as follows :

		Dr. Rs.	Cr. Rs.
Rebate on Bills Discounted A/c	Dr.	22,160	
To Discount on Bills A/c			22,160
(Being the transfer of Rebate on Bills Discounted on 31-3-2007 to Discount on Bills Account)			
Discount on Bills A/c	Dr.	42,317	
To Rebate on Bills Discounted A/c			42,317
(Being the transfer of rebate on bills discounted required on 31-3-2007 from discount on Bills Account)			
Discount on Bills A/c	Dr.	85,551	
To Profit and Loss A/c			85,551
(Being the amount of discount on Bills transferred to Profit and Loss Account)			

Note: In the Profit and Loss Account, the discount on bills will not appear as a separate item but will be included in the heading Interest/Discount on advances/bills as per Form B of the new format.

5.3 ACCEPTANCE AND ENDORSEMENT

A bank has a more acceptable credit as compared to that of its customers. On this account, it is often called upon to accept or endorse bills on behalf of its customers. In such a case, the bank undertakes a liability towards the party which agrees to receive such a bill in payment of a debt or agreed to discount the bill after the same has been accepted by the bank. As against this liability, the bank has a corresponding claim against the customer on whose behalf it has undertaken to be a party to the bill, either as an acceptor or as an endorser. Such liabilities which are outstanding at the close of the year and the corresponding assets are disclosed as contingent liability as per the new format. As a safeguard against the customer not being able to meet the demand of the bank in this respect, usually the bank requires the customer to deposit a security equivalent to the amount of the bill accepted on his behalf. A record of the particulars of the bills accepted as well as of the securities collected from the customers is kept in the Bills Accepted Register. A bank may not treat this book as part of system of its accounts. In such a case no further record of the transactions is kept until the bill matures for payment. If the bill, at the end of its term, has to be retired by the bank and the amount cannot be collected from the customer on demand, the bank reimburses itself by disposing of the security deposited by the customer.

5.3.1 Drafts and telegraphic Remittances - When a bank issues a bank draft on another bank or on its branch, it credits the account of the bank or that of the branch with amount of the draft. The corresponding debit is raised in the account of the customer. His account is also debited with the remittances. A similar procedure is adopted in case of telegraphic transfer made on account of customers.

5.3.2 Letters of Credit and Travellers' Cheques - These are issued as a facility to travellers within the country or abroad. In either case, the person desiring such instruments of credit, to be issued in his favour or some other party is made to deposit the full value of the letter of credit or travellers' cheques issued in his favour.

The amount deposited by the customer is placed to the credit of Letters of Credit Account or Travellers' Cheques Account, as the case may be. When the bills of Exchanges drawn against the Letters of credit are received for payment, the amount is debited to the Letter of Credit Account. Similarly, the travellers' cheques, when presented are debited to the Travellers' Cheque Account. In the case of customers desiring travellers' cheques in a foreign currency, the equivalent value thereof in home currency in collected from them at the rate of exchange prevailing on the date of issue of the traveller's cheque and the bank either purchases immediately the amount of foreign exchange equal to the value of the travellers' cheque issued, or transfers out of its balances of foreign currency an amount equivalent to the value of travellers' cheques to the Travellers' Cheques Account. In the case of letters of credit in foreign currency, the same procedure is followed.

The transactions entered into for rendering other services *e.g.*, collection of dividend and interest, making periodical payments etc. do not involve any complicated accounting. Basically, when any amount is collected for a customer as dividend or interest, his account is credited and cash is debited. Correspondingly, wherever any payment is made on account of a customer, his account is debited and cash is credited. Usually a separate charge is made for such a service.

Illustration 3

On 31st March, 2007, Uncertain Bank Ltd. had a balance of Rs. 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 2008, Uncertain Bank Ltd. discounted bills of exchange of Rs. 4,000 crores charging interest at 18% per annum the average period of discount being for 73 days. Of these, bills of exchange of Rs. 600 crores were due for realisation from the acceptors/customers after 31st March, 2008, the average period outstanding after 31st March, 2008 being 36.5 days.

Uncertain Bank Ltd. asks you to pass journal entries and show the ledger accounts pertaining to :

(i) discounting of bills of exchange and

(ii) rebate on bills discounted.

Solution

Uncertain Bank Ltd.
Journal Entries

(Rupees in crores)

		Dr. Rs.	Cr. Rs.
Rebate on bills discounted A/c	Dr.	9.00	
To Discount on bills A/c			9.00
(Being the transfer of opening balance in rebate on bills discounted account to discount on bills account)			
Bills purchased and discounted A/c	Dr.	4000.00	
To Discount on bills A/c			144.00
$\left[\text{Rs.}4{,}000\,\text{crores}\times\frac{18}{100}\times\frac{73}{365}\right]$			
To Clients A/c			3,856.00
(Being the discounting of bills of exchange during the year)			
Discount on bills A/c	Dr.	10.80	
To Rebate on bills discounted A/c			10.80
(Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward)			

Discount on bills A/c	Dr.	142.20	
To Profit and loss A/c			142.20
(Being the amount of income for the year from discounting of bills of exchange transferred to Profit and Loss A/c)			

Ledger Accounts

(i) **Discount on bills A/c**

2008		*Rs.*	*2007*		*Rs.*
March 31	To Rebate on bills discounted A/c	10.80	April 1	By Rebate on bills discounted A/c	9.00
	To Profit and loss A/c	142.20	2007-08	By Bills purchased and discounted A/c	144.00
		153.00			153.00

(ii) **Rebate on bills discounted A/c**

2007		*Rs.*	2007		*Rs.*
April 1	To Discount on bills A/c	9.00	April 1	By Balance b/d	9.00
2008			2008		
March 31	To Balance c/d	10.80	March 31	By Discount on bills A/c	10.80
		19.80			19.80

Illustration 4

Following facts have been taken out from the records of Adarsha Bank Ltd. in respect of the year ending March 31, 2007 :

(a) On 1-4-2006 Bills for collection were Rs. 7,00,000. During 2006-2007 bills received for collection amounted to Rs. 64,50,000, bills collected were Rs. 47,00,000 and bills dishonoured and returned were Rs. 5,50,500. Prepare Bills for Collection (Assets) A/c and bills for Collection (Liability) A/c.

(b) On 1-4-2006, Acceptance, Endorsement, etc. not yet satisfied amounted to Rs. 14,50,000. During the year under question, Acceptances, Endorsements, Guarantees etc., amounted to Rs. 44,00,000. Bank honoured acceptances to the extent of Rs. 25,00,000 and client paid off Rs. 10,00,000 against the guaranteed liability. Clients failed to pay Rs. 1,00,000 which the Bank had to pay. Prepare the "Acceptances, Endorsements and other ObligationsA/c" as it would appear in the General ledger.

(c) It is found from the books, that a loan of Rs. 6,00,000 was advanced on 30-9-2007 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31-3-2008 without any payment recorded in the meantime, either towards principal or towards interest. The security for the loan was 10,000 fully paid shares of Rs. 100 each (the market value was Rs. 98 as per the Stock Exchange information as on 30th Sept., 2007). But due to fluctuations, the price fell to Rs. 40 per share in January, 2008. On 31-3-2008, the price as per Stock Exchange rate was Rs. 82 per share. State how you would classify the loan as secured/unsecured in the Balance Sheet of the Company.

(d) The following balances are extracted from the Trial Balance as on 31-3-2008 :

	Dr.	*Cr.*
	Rs.	*Rs.*
Interest and Discounts		98,00,000
Rebate for bills discounted		20,000
Bills discounted and purchased	4,00,000	

It is ascertained that the proportionate discounts not yet earned for bills to mature in 2007-2008 amount to Rs. 14,000. Prepare Ledger Accounts.

Solution

(a) **Bills for Collection (Assets) A/c**

2006		*Rs.*	*2006-07*	*Rs.*
Apr. 1	To Balance b/d	7,00,000	By Bills for Collection (Liabilities) A/c	47,00,000
2006-07	To Bills for Collection (liabilities) A/c	64,50,000	By Bills for collection (Liabilities) A/c	5,50,500
			2005	
			Mar. 31 By Balance c/d	18,99,500
		71,50,000		71,50,000

Bills for Collection (Liabilities) A/c

		Rs.			Rs.
2006-07	To Bills for collection		2006		
	(Assets) A/c	47,00,000	Apr. 1	By Balance b/d	7,00,000
	To Bills for Collection		2006-07	By Bills for collection	64,50,000
	(Assets) A/c	5,50,500		(Assets) A/c	
2007					
Mar. 31	To Balance c/d	18,99,500			
		71,50,000			71,50,000

(b) **Acceptances, Endorsement & other Obligation A/c**

2006-07		Rs.	2006		Rs.
	To constituents' Liability for Acceptance, Endorsement, etc.	25,00,000	Apr. 1	By Balance b/d	14,50,000
	To Constituents' Liability for Acceptances, Endorsement etc.	10,00,000	2006-07	By constituents, Liabilities for Acceptances, Endorsements, etc.	44,00,000
	To Constituents' Liability for Acceptances, Endorsements, etc. (amount paid on failure of clients)	1,00,000			
Mar. 31	To Balance c/d	22,50,000			
		58,50,000			58,50,000

(c) For classifying loans as fully secured or otherwise, the value of the security as on the last date of the year is considered. The value of the security is Rs. 8,20,000 covering the loan and the interest due comfortably. Hence it is to be treated as good and fully secured.

(d) **Rebate on Bills Discounted A/c**

		Rs.			Rs.
2007-08	To Interest and Discount A/c	6,000	2007		
			Apr. 1	By Balance b/d	20,000
2008 Mar. 31	To Balance c/d	14,000			

		20,000			20,000

Interest & Discount Account

2008		*Rs.*	*2007*		*Rs.*
Mar. 31	To Profit & Loss A/c	98,06,000	Apr. 1	By Balance b/d	98,00,000
			2007-08	By Rebate on Bills discounted A/c	6,000
		98,06,000			98,06,000

5.4 STATUTORY LIQUIDITY RATIO (SLR) FOR SCHEDULED COMMERCIAL BANKS

Commercial banks are required to maintain Statutory Liquidity Ratio and Cash Reserve Ratio under Section 42 of the RBI Act, 1934 and Sections 18 and 24 of the Banking Regulation Act, 1949. For SLR, all scheduled commercial banks (excluding regional rural banks) are required to maintain in India in the form of cash, gold or unencumbered approved securities, Statutory Liquidity Ratio (SLR) of 31.50 per cent on domestic liabilities upto the level outstanding as on September 30, 1994, and 25 per cent on any increase in such liabilities over the level outstanding as on September 30, 1994 (under Section 24 of the Banking Regulation Act, 1949).

The liabilities for this purpose include liabilities (inter-bank liabilities) to banking system computed as provided in clause (*d*) of Explanation to Section 18(1) of the Banking Regulation Act, 1949. It has been decided that with effect from the fortnight beginning on April 26, 1997, these inter-bank liabilities shall be excluded from the maintenance of SLR. Further rationalisation was effected on October, 1997 when the multiple SLR prescriptions were replaced by a single uniform SLR of 25 per cent for the entire net demand and time liabilities.

5.5 CASH RESERVE RATIO (CRR) FOR SCHEDULED COMMERCIAL BANKS

As per Section 42 sub-section (7) of the Reserve Bank of India Act, 1934, all Scheduled Commercial Banks (excluding regional rural banks) were required to maintain CRR of 10 per cent on liabilities to the banking system. With a view to facilitate the development of a more realistic rupee yield curve and term money market, it has been decided to exempt the liabilities to the banking system from maintenance of CRR. Accordingly with effect from the fortnight beginning on April 26, 1997, liabilities to the banking system as computed under clause (*b*) of Explanation to Section 42(1) of the Reserve Bank of India Act, 1934, are exempted from maintenance of CRR of 10 per cent. Presently, the CRR in present at 9 per cent in the year 2008.

In view of the multiple prescriptions on different categories of liabilities, including of prescription of a zero reserve requirement on some liabilities as stipulated under law, effective CRR maintained by commercial banks on total Demand and Time Liabilities should not be less than 9 per cent as computed under Section 42(1) of the Reserve Bank of India Act, 1934.

Incremental CRR on Non-Resident Deposits

With effect from April 26, 1997, all scheduled commercial banks (excluding RRBs) are required to maintain an incremental CRR on the increase in liabilities under FCNR (B) account scheme, NRE accounts scheme and NRNR accounts scheme over the level outstand ing as on April 11, 1997. In respect of liabilities under NRE accounts scheme, CRR maintained under this measure would be in addition to CRR, if any, required to be maintained under Section 42(1A) of the Reserve Bank of India Act, 1934.

Penal rate of interest on the shortfalls in the maintenance of CRR/SLR

Non-compliance with the SLR and CRR requirements will attract penal action against the concerned banks. The penal rate of interest charged on the amount of shortfalls in the maintenance of CRR and SLR, is linked to the bank rate.

SELF-EXAMINATION QUESTIONS

I. Objective Type Questions

Pick up the most appropriate answer from the given options:

1. On 1.4.2004 Bills for collection were Rs. 10,000. During 2004-2005 bills received for collection amounted to Rs. 1,00,000, bills collected were Rs. 80,000 and bills dishonoured and returned were Rs. 5,000. What will be the amount of bill for collection (assets) to be shown in the Balance Sheet as on 31.3.2005?
   (a) 25,000
   (b) 30,000
   (c) 35,000
   (d) None of the above.
2. Rebate on bill discounted is shown in the
   (a) Assets side of the balance sheet.
   (b) liabilities side of the balance sheet.
   (c) Income side of the income statement.
   (d) Expense side of the income statement.
3. Bills for collection are shown

(a) on Assets side of the balance sheet.

(b) on liabilities side of the balance sheet.

(c) on the income side of the income statement.

(d) as note below the balance sheet.

[**Answer 1**-(a); **2**- (b); **3**-(d)]

II. Short Answer Type Questions

4. What is meant by incremental cash reserve ratio?
5. Define acceptances and endorsements.

III. Long Answer Type Questions

6. Explain in detail "Letter of Credit and Traveller's Cheque

IV. Practical Problems

7. What is rebate on bills discounted? From the following information calculate the rebate:

Bills discounted due date of which is beyond 31st March, 2008	*Due Date*	*Rate of Discount*
1. Rs. 1,20,000	9th Sept., 2001	12
2. Rs. 1,00,000	7th May, 2001	14
3. Rs. 50,000	7th Aug., 2001	16

UNIT - 6 : PREPARATION OF FINANCIAL STATEMENTS OF BANKS

Learning Objectives

After studying this unit, you will be able to:

- Learn how to prepare profit and loss account of a bank.
- Compute tax provision, transfer to statutory reserve, provisions on non-performing assets, income recognition on NPA, depreciation on current investments.
- Learn how to prepare Balance-sheet..

6.1 INTRODUCTION

Forms for the preparation and presentation of financial statements of banking companies have been given in Unit 2 along with compilation guidelines of the RBI. In this Unit we shall straightaway go to the problems relating to preparation of final accounts of banks.

Illustration 1

From the following information, prepare a Balance Sheet of International Bank Ltd. as on 31st March, 2008 giving the relevant schedules and also specify at least four important Principal Accounting Polcies :

Rs. in lakhs

	Dr.	Cr.
Share Capital		198.00
19,80,000 Shares of Rs. 10 each		
Statutory Reserve		231.00
Net Profit Before Appropriation		150.00
Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	

Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	
Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
	2,588.22	2,588.22

Additional Information :

Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledged as debt	55,000
Depreciation charges—Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees. 10% of cash credit is unsecured. Also calculate cash reserves required and statutory liquid reserves required.

Note : Cash reserves required 3% of demand and time liabilities; liquid reserves required 30% of demand and time liabilities.

Solution

Balance Sheet of International Bank Ltd.

As on 31st March, 2008

(Rs. in lacs)

Capital and Liabilities	**Schedule**	**As on 31.3.08**	**As on 31.3.07**
Share Capital	1	1,98.00	
Reserves and Surplus	2	7,93.00	
Deposits	3	14,87.12	
Borrowings	4	1,10.00	
Other liabilities and provisions	5	0.10	
		25,88.22	

Assets		
Cash and balances with RBI	6	2,04.76
Balances with banks and money at call and short notice	7	3,59.26
Investments	8	1,65.40
Advances	9	16,32.98
Fixed Assets	10	2,25.82
Other Assets	11	–
		25,88.22
Contingent liabilities	12	14.67
Bills for collection		18.10

Schedule 1— Capital

Authorised Capital	–
Issued, Subscribed and Paid up Capital	
19,80,000 Shares of Rs. 10 each	1,98.00

Schedule 2— Reserves and Surplus

(1) Statutory Reserve-		
Opening balance	2,31.00	
Additions during the year	37.50	
		268.50
(2) Balance in Profit & Loss Account *(W.N. 1)*		524.50
		7,93.00

Schedule 3— Deposits

(i) Demand deposits from others	5,20.12
(ii) Saving bank deposits	4,50.00
(iii) Fixed Deposits	5,17.00
	14,87.12

Schedule 4— Borrowings

Borrowing in India-	
Other banks	1,10.00

Schedule 5— Other Liabilities and Provisions

Other liabilities and provisions	0.10

Schedule 6— Cash and balances with RBI

(i) Cash in hand	1,60.15
(ii) Balances with RBI	
In current account *(W.N. 2)*	44.61
	2,04.76

Schedule 7—Balances with banks and money at call and short notice

1. In India	
(i) Balances with banks	
(a) in current accounts *(W.N. 3)*	1,49.14
(ii) Money at call and short notice	2,10.12
	3,59.26

Schedule 8— Investments

(1) Investment in India in	
(i) Government securities	1,10.17
(ii) Others—Gold	55.23
	1,65.40

Schedule 9— Advances

A. (i) Cash credits, overdrafts	8,40.10
(ii) Term Loans	7,92.88
	16,32.98

B (i)	Secured by tangible assets	11,52.53
(ii)	Secured by bank/government guarantees	3,96.44
(iii)	Unsecured	84.01
		16,32.98

Schedule 10— Fixed Assets

1. Premises	
At cost on 31st March, 2007	156.80
Depreciation to date	1.10
	155.70
2. Other Fixed Assets	
Furniture at cost on 31st March, 2007	70.90
Depreciation to date	0.78
	70.12
Total (1 + 2)	2,25.82

Schedule 11— Other Assets

Nil

Schedule 12— Contingent Liabilities

(i)	Claims against bank not acknowledged as debts	0.55
(ii)	Acceptances, endorsements	14.12
		14.67

Calculation of cash reserves and statutory liquid reserves

Total of demand and time liabilities	
(Rs. 5,17.00 + Rs. 4,50.00 + Rs. 5,20.12)	14,87.12
Cash reserves (3% of above)	44.61
Statutory liquid reserves	
(30% of demand and time liabilities)	4,46.14

Working Note :

(1) Balance in Profit & Loss Account :

Net Profit before appropriation	1,50.00
Add : Profit for the year	4,12.00
	5,62.00
Less : Transfer to statutory reserve	
(25% of 1,50.000)	37.50
	524.50

(2) Transfer from Cash with other banks to Cash with RBI

Cash reserve required	44.61
Cash with RBI	37.88
Transfer needed to maintain cash reserve	6.73

(3) Liquid Assets :

Cash on hand	1,60.15
Cash with other Banks	1,55.87
Money at call and short notice	2,10.12
Gold	55.23
Government securities	1,10.17
	6,91.54
Excess liquidity (6,91.54 – 4,46.14)	2,45.40

The excess liquidity enables the transfer as per(2) above.

After the transfer, cash with other Banks = Rs. (in lacs) (1,55.87 - 6.73) = Rs (in lacs) 1,49.14

Principal Accounting Policies :

(a) Foreign Exchange Transactions

(i) Monetary assets and liabilities have been translated at the exchange rate prevailing at the close of year. Non-monetary assets have been carried in the books at the historical cost.

(ii) Income and Expenditure items in respect of Indian branches have been translated at the exchange rates on the date of transactions and in respect of foreign branches at the exchange rates prevailing at the close of the year.

(iii) Profit or Loss on foreign currency position including pending forward exchange contracts have been accounted for at the exchange rates prevailing at the close of the year.

(b) Investment : Permanent category investments are valued at cost. Valuation of investment in current category depends on the nature of securities. While valuation of government securities held as current investments have been made on yield to maturity basis, the investments in shares of companies are valued on the basis of book value.

(c) Advances : Advances due from sick nationalised units under nursing programmes and in respect of various sticky, suit filed and decreed accounts have been considered good on the basis of–

(i) Available estimate value of existing and prospective primary and collateral securities including personal worth of the borrowers and guarantors.

(ii) The claim lodged/to be lodged under various credit guarantee schemes.

(iii) The claim lodged/to be lodged under various credit guarantee schemes.

(iv) Pending settlement of claims by Govt.

Provisions to the satisfaction of auditors have been made and deducted from advances. Tax relief available when the advance is written off will be accounted for in the year of write-off.

(d) Fixed Assets: The premises and other fixed assets except for foreign branches are accounted for at their historical cost. Depreciation has been provided on written down value method at the rates specified in the Income Tax Rules, 1962. Depreciation in respect of assets of foreign branches has been provided as per the local laws.

Illustration 2

From the following information, prepare Profit and Loss A/c of Modern Bank Ltd. as on 31-3-2008 :

'000 Rs.	*Item*	*'000 Rs.*
2006-2007		2005-06
14,27	Interest and Discount	20,45
1,14	Income from investment	1,12
1,55	Interest on Balances with RBI	1,77
7,22	Commission, Exchange and Brokerage	7,12
12	Profit on sale of investments	1,22

6,12	Interest on Deposits	8,22
1,27	Interest to RBI	1,47
7,27	Payment to and provision for employees	8,55
1,58	Rent, taxes and lighting	1,79
1,47	Printing and stationery	2,12
1,12	Advertisement and publicity	98
98	Depreciation	98
1,48	Director's fees	2,12
1,10	Auditor's fees	1,10
50	Law charges	1,52
48	Postage, telegrams and telephones	62
42	Insurance	52
57	Repair & maintenance	66

Also give necessary Schedules.

Other Information:

(i) The following items are already adjusted with Interest and Discount (Cr.):

Tax Provision ('000 Rs.)	1,48
Provision for Doubtful Debts ('000 Rs.)	92
Loss on sale of investments ('000 Rs.)	12
Rebate on Bills discounted ('000 Rs.)	55

(ii) Appropriations :

25% of profit is transferred to Statutory Reserves

5% of profit is transferred to Revenue Reserve.

Solution

Modern Bank Ltd.

Profit and Loss Account for the year ended 31-3-2008

		Schedule No.	Year ended 31-3-2006	Year Ended 31-3-2005
				(Rs. 000's)
I.	**Income**			
	Interest Earned	13	26,41	16,96
	Other Income	14	8,22	7,34
	Total		34,63	24,30
II.	**Expenditure**			
	Interest Expended	15	9,69	7,39
	Operating Expenses	16	20,96	16,97
	Provisions and Contingencies		2,95	—
	Total		33,60	24,36
III.	**Profit/Loss**			
	Net Profit/Loss (—) for the year		1,03	(6)
	Profit/Loss (—) brought forward		(6)	—
	Total		97	(6)
IV.	**Appropriations**			
	Transfer to Statutory Reserve		25.75	
	Transfer to Other Reserve, Proposed Dividend		5.15	
	Balance carried over to Balance Sheet		66.10	
	Total		97.00	

Schedule 13 - Interest Earned

		Year ended 31-3-2006	Year Ended 31-3-2005
			(Rs. 000's)
I.	Interest/Discount	23,52	14,27
II.	Income on Investments	1,12	1,14
III.	Interest on Balances with RBI and other inter-bank fund	1,77	1,55
IV.	Others		
	Total	26,41	16,96

Schedule 14 - Other Income

			Year ended 31-3-2006	Year Ended 31-3-2005
I.	Commission, Exchange and Brokerage		7,12	7,22
II.	Profit on Sale of Investments	1,22		
	Less: Loss on sale of Investments	12	1,10	12
	Total		8,22	7,34

Schedule 15 - Interest Expended

		Year ended 31-3-2006	Year Ended 31-3-2005
I.	Interest on Deposits	8,22	6,12
II.	Interest on RBI/inter-bank borrowings	1,47	1,27
	Total	9,69	7,39

Schedule 16 - Operating Expenses

		Year ended 31-3-2006	Year Ended 31-3-2005
I.	Payments to and provision for employees	8,55	7,27
II.	Rent, taxes and lighting	1,79	1,58
III.	Printing and stationery	2,12	1,47
IV.	Advertisement and Publicity	98	1,12
V.	Depreciation on the Bank's Property	98	98
VI.	Director's fees, allowances and expenses	2,12	1,48
VII.	Auditor's fees and expenses (including branch auditors)	1,10	1,10

VIII.	Law charges	1,52	50
IX.	Postage, telegrams, telephones etc.	62	48
X.	Repairs and maintenance	66	57
XI.	Insurance	52	42
XII.	Other Expenditure		
	Total	20,96	16,97

Illustration 3

From the following information, prepare Profit and Loss A/c of Hyderabad Bank Ltd. for the year ended 31st March, 2008.

Items	*000 Rs.*
Interest on cash credit	18,20
Interest on overdraft	7,50
Interest on term loans	15,40
Income on investments	8,40
Interest on balance with RBI	1,50
Commission on remittances and transfer	75
Commission on letters of credit	1,18
Commission on government business	82
Profit on sale of land and building	27
Loss on exchange transactions	52
Interest paid on deposit	27,20
Auditors' fees and allowances	1,20
Directors' fees and allowances	2,50
Advertisements	1,80
Salaries, allowances and bonus to employees	12,40
Payment to Provident Fund	2,80
Printing and stationery	1,40
Repairs and maintenance	50
Postage, telegrams, telephones	80

Other Information:

(i) Interest on NPA is as follows

	Earned (Rs. '000)	*Collected (Rs. '000)*
Cash credit	8,20	40,00
Overdraft	450	1,00
Term Loans	750	2,50

(ii) Classification of advances ('000 Rs.)

Standard	30,00
Sub-standard	11,20
Doubtful assets not covered by security	2,00
Doubtful assets covered by security for one year	50
Loss Assets	2,00

(iii) Investments 27,50

Bank should not keep more than 25% of its investment as 'held-for-maturity' investment. The market value of its best 75% investment is Rs. 6,00,000 as on 31-3-2008.

Solution

Hyderabad Bank Ltd.

Profit and Loss Account

For the year ended 31st March, 2008

		Schedule	*(Rs. '000')* Year Ended 31-3-2001
I	Income		
	Interest earned	13	38,30
	Other income	14	2,50
			40,80
II	Expenditure		
	Interest expended	15	27,20
	Operating expenses	16	23,40
	Provisions and Contingencies		621.5
			56,81.5

III	Profit/Loss		(16,01.5)
IV	Appropriations		Nil

Schedule 13 - Interest Earned

			Year Ended 31-3-2001
I	Interest/discount on advances/bills		
	Interest on cash credit (1820-420)	14,00	
	Interest on overdraft (750-350)	4,00	
	Interest on term loans (1540-500)	10,40	28,40
II	Income on investments		8,40
III	Interest on Balance with RBI		1,50
			38,30

Interest on NPA is recognised on cash basis.

Schedule 14 - Other Income

I	Commission, Exchange and Brokerage		
	Commission on remittances and transfer	75	
	Commission on letter of credit	1,18	
	Commission on Government business	82	2,75
IV	Profit on sale of Land and Building		27
V	Loss on Exchange Transactions		(52)
			2,50

Schedule 15 - Interest Expended

I	Interest on Deposits	27,20

Schedule 16 - Operating Expenses

I	Payment and provision for employees		
	Salaries, allowances and bonus	12,40	
	Provident Fund Contribution	2,80	15,20

III	Printing and Stationery	1,40
IV	Advertisement and publicity	1,80
VI	Directors' fees, allowances and expenses	2,50
VII	Auditors' fees and expenses	1,20
IX	Postage, telegrams, telephones etc.	80
X	Repairs and maintenance	50
		23,40

Working Note:

Provisions and contingencies			*(Rs. '000)*
Provision for NPA :			
Standard	3000 × 0.40		12
Sub-standard	1120 × 10		1,12
Doubtful not covered by security	200 × 100%		2,00
Doubtful covered by security for one year	50 × 20		10
Loss Assets	(200 × 100%)		2,00
			534
Depreciation on current investments			
Cost 25% of 27,50		687.50	
Less : Market value		600.00	87.5
			621.5

Illustration 4

The following are the ledger balances (in Rupees thousands) extracted from the books of Vaishnavi Bank Limited as on March 31, 2008 :

	Dr.	*Cr.*
Share Capital		19,00,00
Current accounts control		9,70,00
Employee security deposits		74,20
Investments in Govt. of India Bonds	9,43,70	
Gold Bullion	1,51,30	
Silver	20,00	

It is assumed that sub-standard asset is fully secured.

Constituent liabilities for		
acceptances and endorsements	5,65,00	5,65,00
Borrowings from banks		7,72,30
Building	6,50,00	
Furniture	50,00	
Money at call and short notice	2,60,00	
Commission & brokerage		2,53,00
Saving accounts		1,50,00
Fixed deposits		2,30,50
Balances with other banks	4,63,50	
Other investments	5,56,30	
Interest accrued on investments	2,46,20	
Reserve Fund		14,00,00
P & L A/c		65,00
Bills for collection	4,35,00	4,35,00
Interest		6,20,00
Loans	18,10,00	
Bills discounted	1,25,00	
Interest	79,50	
Discounts		4,20,00
Rents		6,00
Audit fees	50,00	
Depreciation reserve (furniture)		2,00
Salaries	2,12,00	
Rent, rates and taxes	1,20,00	
Cash in hand and with Reserve Bank	7,50,00	
Miscellaneous income		39,00
Depreciation reserve (building)		8,00
Directors fees	10,00	
Postage	12,50	
Loss on sale of investments	2,00,00	
Branch adjustments	2,00,00	
	79,10,00	79,10,00

Other Information:

The bank's Profit and Loss Account for the year ended and Balance Sheet as on 31st March, 2008 are required to be prepared in appropriate form. Further information (in Rupees thousands) available is as follows —

(a) Rebate on bills discounted to be provided 40,00

(b) Depreciation for the year

Building 50,00

Furniture 5,00

(c) Included in the current accounts ledger are accounts overdrawn to the extent of 25,00.

Solution

Balance Sheet of Vaishnavi Bank Ltd.
as on 31st March, 2008

			('000 Rs.)
Capital and Liabilities	*Schedule*	*As on 31-3-2008*	*As on 31-3-2007*
Capital	1	19,00,00	
Reserves & Surplus	2	20,24,00	
Deposits	3	13,75,50	
Borrowings	4	7,72,30	
Other liabilities and provisions	5	1,14,20	
Total		61,86,00	

			('000 Rs.)
Assets	*Schedule*	*As on 31-3-2008*	*As on 31-3-2007*
Cash and balance with Reserve Bank of India	6	7,50,00	
Balances with bank and Money at call and short notice	7	7,23,50	
Investments	8	16,71,30	
Advances	9	19,60,00	

Fixed Assets	10	6,35,00
Other Assets	11	4,46,20
Total		61,86,00
Contingent liabilities	12	5,65,00
Bills for collection		4,35,00

Vaishnavi Bank Ltd.

Profit and Loss Account for the year ended 31-3-2008

I. Income		
Interest & Discount	13	10,40,00
Other income	14	98,00
		11,38,00
II. Expenditure		
Interest Expended	15	79,50
Operating Expenses	16	4,59,50
Provisions and Contingencies		40,00
		5,79,00
III. Profits/Loss		
Net profit for the year		5,59,00
Profit b/f		65,00
		6,24,00
IV. Appropriations		
Transfer to Statutory Reserve		1,39,75
Balance carried over to Balance Sheet		4,84,25
		6,24,00

Schedule 1 - Capital

(Rs. '000)

	As on 31-3-2008	As on 31-3-2007
III. For Other Banks		
Authorised Capital		
Shares of Rs. ... each		

	Issued Capital		
	Shares of Rs. ... each		
	Subscribed Capital		
	Shares of Rs. ... each		
	Called up capital		
	Shares of Rs. ... each	19,00,00	
		19,00,00	

Schedule 2 - Reserves & Surplus

I.	**Statutory Reserves**		
	Opening Balance	14,00,00	
	Additions during the year	1,39,75	
		15,39,75	
V.	Balance in Profit and Loss Account	4,84,25	
	Total	20,24,00	

Schedule 3 - Deposits

			(Rs. '000)
		As on 31-3-2008	*As on 31-3-2007*
A. I.	Demand Deposits	9,95,00	
II.	Saving Bank Deposits	1,50,00	
III.	Term Deposits	2,30,50	
		13,75,50	

Schedule 4 - Borrowings

I.	Borrowings in India		
(ii)	Other banks	7,72,30	
	Total	7,72,30	

Schedule 5 - Other liabilities and provisions

IV.	Other liabilities including provisions:	
	Rebate on bills discounted	40,00
	Employees Security Deposit	74,20
	Total	1,14,20

Schedule 6 - Cash and Balances with Reserve Bank of India

I.	Cash in hand (including foreign currency notes)	3,50,00
II.	Balances with Reserve Bank of India:	
	(i) In Current Account	3,20,00
	(ii) In Other Account	80,00
	Total	7,50,00

(Details are not based on figures given in the question)

Schedule 7 - Balances with Banks & Money at Calls & Short Notice

I.	In India	
	(i) Balances with banks	
	(*a*) in Current accounts	2,63,50
	(*b*) in Other accounts	2,00,00
	(ii) Money at call and short notice	
	(*a*) with banks	2,30,00
	(*b*) with other institutions	30,00
	Total	7,23,50

Schedule 8 - Investments

		As on 31-3-2008	('000 Rs.) As on 31-3-2007
I. Investments in India in			
(i) Government securities		9,43,70	
(ii) Shares (assumed)		5,56,30	
(vi) Gold		1,51,30	
Silver		20,00	
Total		16,71,30	

Schedule 9 - Advances

A. (i) Bills purchased and discounted		1,25,00	
(ii) Cash credits, overdrafts and loans repayable on demand		18,35,00	
		19,60,00	
B. (i) Secured by tangible assets		12,00,00	
(ii) Secured by Bank/Govt. Securities		2,00,00	
(iii) Unsecured		5,60,00	
		19,60,00	
C. I. Advances in India			
(i) Priority sector		8,00,00	
(ii) Public sector		1,00,00	
(iii) Banks		20,00	
(iv) Others		10,40,00	
Total		19,60,00	

(Details are assumed)

Schedule 10 - Fixed Assets

I. Premises			
At cost as on 31st March, 2007	6,42,00		
Depreciation to date	50,00		
		5,92,00	
II. Other fixed articles (including Furniture and Fixture)			
At cost as on 31st March, 2007	48,00		
Depreciation to date	5,00	43,00	
Total (I & II)		6,35,00	

Schedule 11 - Other Assets

		('000 Rs.)	
		As on 31-3-2008	*As on 31-3-2007*
I. Inter-office adjustments (net)		2,00,00	
II. Interest accrued		2,46,20	
		4,46,20	

Schedule 12 - Contingent Liabilities

		Year ended 31-3-2008	*Year ended 31-3-2007-*
V. Acceptances, endorsements and other obligations		5,65,00	
Total		5,65,00	

Schedule 13 : Interest Earned

I. Interest/discount on advances, bills		7,93,80	
II. Income on Investments		2,46,20	
Total		10,40,00	

Schedule 14 : Other Income

I. Commission, Exchange and Brokerage	2,53,00		
II. Profit on sale of investments			
Less : Loss on sale on investments	2,00,00	53,00	
VII. Miscellaneous Income			
Rent and Other Receipts		45,00	
Total		98,00	

Schedule 15 : Interest Expended

I. Interest on Deposits		79,50	
Total		79,50	

Schedule 16 : Operating Expenses

I. Payments to and provisions for employees		2,12,00	

II.	Rent, Taxes and Lighting	1,20,00
V.	Depreciation on Bank's property	55,00
VI.	Director's fees, allowances and expenses	10,00
VII.	Auditor's fees and expenses	50,00
IX.	Postage, Telegrams, Telephones etc.	12,50
	Total	4,59,50

SELF-EXAMINATION QUESTIONS

Practical Questions

1. From the following information prepare Profit and Loss Account of Jaipur Bank Ltd. for the year ended 31st March, 2008

	Figures are in Rs. thousands
Interest earned on term loans	15,12
Interest earned on term loans classified as NPA	5,12
Interest received on term loans classified as NPA	1,12
Interest on cash credits and overdrafts	27,72
Interest earned but not received on cash credit and overdraft treated as NPA	7,72
Commission	1,12
Loss on sale on investments	10,12
Profit on revaluation of investment	1,12
Income from investments	17,80
Salaries, bonus and allowances	15,10
Rent, taxes and lighting	1,20
Printing and stationery	80
Directors' fees, allowances, expenses	1,12
Law charges	12
Repairs and maintenance	15
Insurance	20

Other information :

Make necessary provision on risk assets :

(i)	Sub-standard	10,00
(ii)	Doubtful for one year	8,00
(iii)	Doubtful for two years	1,20
(iv)	Loss assets	80

The Bank has classified investments costing Rs. 400 thousand as current investment, market value of which is Rs. 380 thousand.

2. From the following balances prepare Balance Sheet of Calcutta Bank Ltd. for the year ended 31st March, 2008 :

	Figures in Thousand Rupees
Equity share capital	10,00
Statutory reserve	5,00
Appropriation to statutory reserve	2,00
P & L A/c balance	7,00
Capital reserve	2,00
Demand deposits	12,00
Saving bank deposits	14,00
Term deposits	10,00
Borrowing from RBI	12,00
Borrowing from other banks	52,70
Bills payable	15,00
Inter-office adjustments (Cr.)	7,00
Cash in hand	7,00
Balance with RBI	12,70
Money at call and short notice	22,50
Investment in govt. securities	14,00
Investment in shares	22,50
Cash credits	17,50
Overdrafts	15,00
Term Loans	25,00
Premises	12,50

3. From the following Trial Balance and other information prepare Final Accounts of Jay Bank Ltd. for the year ending 31st March, 2008 :

	Dr.	*Cr.*
Interest on advance		12,87,000
Interest from investments		6,12,000
Interest on deposits	6,17,000	
Interest on borrowings	1,17,000	
Salaries	4,17,000	
Printing and stationery	87,000	
Postage telegrams and telephones	1,17,000	
Repairs	57,000	
Terms Loans	15,14,000	
Cash credits	30,42,000	
Overdrafts	14,12,000	
Saving deposits		19,17,000
Current accounts		22,14,000
Fixed deposits		10,90,000
Borrowing from other banks		24,48,000
Investment in Government security	12,14,000	
Investment in stocks	16,90,000	
Deposits with RBI	9,10,000	
Cash in hand	9,12,000	
Certificate of deposits with other banks	8,12,000	
Equity share capital		18,00,000
Statutory reserves		15,50,000
	1,29,18,000	1,29,18,000

Other information :

(i) Interest on advances includes Rs. 3,00,000 on NPA of which Rs. 1,25,000 have only been received.

(ii) Make tax provision to the extent of 50% of profit.

(iii) 25% of the profit is to be transferred to statutory reserve and 5% to the revenue reserve.

CHAPTER 7

FINANCIAL STATEMENTS OF ELECTRICITY COMPANIES

UNIT –1: RELEVANT LEGAL PROVISIONS

Learning Objectives

After studying this unit, you will be able to:

- Understand the accounting technique of an electricity companies.
- Know the legal framework applicable for electricity companies.
- Understand the composition and purposes of various statutory authorities.

1.1 INTRODUCTION

Electricity supply undertakings are governed by the Indian Electricity Act, 1910, the Electricity (Supply) Act, 1948 and the Indian Electricity Rules, 1956. Also there are State legislations relating to electricity supply. Some State legislations are the Punjab Electricity Act, 1939, the W.B. Electricity (Emergency Powers) Act, 1948, the Madras Electricity Duty Act, 1939, the Madras Electricity Duty Rules, 1939, the Madras Electricity (Validation of Levy Surcharges) Act, 1949, the UP Electricity Duty Act, 1942, the UP electricity Duty Rules, 1942 etc. Some relevant legal provisions are discussed in this unit.

1.2 CENTRAL ELECTRICITY AUTHORITY

Under Section 3 of the Electricity (Supply) Act, 1948, the Central Government has the power to constitute a body called Central Electricity Authority generally to exercise such functions and perform such duties under the Act in such a manner as the Central Government may describe or direct, and in particular to :

(i) develop a sound adequate and uniform national power policy, formulate short-term and perspective plans for power development and co-ordinate the activities of the planning agencies in relation to the control and utilisation of national power resources;

(ii) act as arbitrators in matters arising between the State Government or the Board and a licensee or other person as provided in this Act;

(iii) collect and record the data concerning the generation, distribution and utilisation of power and carry out studies relating the cost, efficiency, losses, benefits and such like matters :

(iv) make public from time to time information secured under this Act and to provide for the publication of reports and investigations;

(v) advise any State Government, Board, Generating Company or other agency engaged in the generation or supply of electricity on such matters as will enable such Government, Board, Generating Company or agency to operate and maintain the power system under its ownership or control in an improved manner and where necessary, in co-ordination with any other Government, Board, Generating Company or other agency owning or having the control of another power system;

(vi) promote and assist in the timely completion of schemes sanctioned under Chapter V;

(vii) make arrangements for advancing the skill of persons in the generation and supply of electricity;

(viii) carry out, or make arrangements for, any investigation for the purpose of generating or transmitting electricity;

(ix) promote research in matters affecting the generation, transmission and supply of electricity;

(x) advise the Central Government on any matter on which its advice is sought or make recommendation to that Government on any matter if, in the opinion of the Authority, the recommendation would help in improving the generation, distribution and utilisation of electricity; and

(xi) Discharge such other functions as may be entrusted to it by or under any other law.

A full time member of the Central Electricity Authority must be an expert in the area of:

(a) Design, construction, operation and maintenance of generating stations;

(b) Transmission and supply of electricity;

(c) Applied research in the field of electricity;

(d) Applied economics; or

(e) Industrial, commercial or financial matters.

The Central Government appoints one of the full time members to be the chairman of the Authority. All the members of the Authority shall hold the office during the pleasure of the Central Government.

1.3 STATE ELECTRICITY BOARD

Under Section 5 of the Electricity (Supply) Act, 1948, State Government has the authority to constitute the State Electricity Board. The Board consists of not less than 3 or not more than 7 members to be appointed by the State Government. Of the members one shall be a person who has experience and has shown capacity in commercial matters and administration; one shall be an electrical engineer with wide experience; and one shall be a person who has experience in functioning of financial matters in a public utility undertaking, preferably in an electricity supply undertaking. One of the members of the Board shall be appointed by the State Government to be the Chairman of the Board.

General duties of the Board: Subject to the provisions of this Act, the Board shall be charged with the following general duties, namely :

(a) to arrange, in co-ordination with the Generating Company or Generating Companies, if any, operating in the State, for the supply of electricity that may be required within the State and for the transmission and distribution of the same in a most efficient and economical manner with particular reference to those areas which are not for the time being supplied or adequately supplied with electricity;

(b) to supply electricity as soon as practicable to a licensee or other person requiring such supply if the Board is competent under this Act so to do;

(c) to exercise such control in relation to the generation, distribution and utilisation of electricity within the State as is provided for by or under this Act;

(d) to collect data on the demand for, and the use of, electricity and to formulate perspective plans in co-ordination with the Generating Company or Generating companies, if any, operating in the State for the generation, transmission and supply of electricity within the State;

(e) to prepare and carry out schemes for transmission, distribution and generally for promoting the use of electricity within the State; and

(f) to operate the generating stations under its control in co-ordination with the Generating Company or Generating Companies, if any, operating in the State and with the Government or any other Board or agency having control over a power system [Section 18 of Electricity (Supply) Act].

Powers of the Board to supply electricity: (1) The Board may, subject to the provision of this Act, supply electricity to any licensee or person requiring such supply in any area in which a scheme sanctioned under Chapter V is in force:

Provided that the Board shall not:

(a) Supply electricity for any purpose directly to any licensee for use in any part of the area of supply of a bulk-licensee without the consent of the bulk-licensee, unless the licensee to be supplied has an absolute right of veto on any right of the bulk-licensee to supply electricity for such purpose in the said part of such area, or unless the bulk-licensee is unable or unwilling to supply electricity for such purpose in the said part of such area on reasonable terms and conditions and within a reasonable time, or

(b) Supply electricity for any purpose to any person, not being a licensee for use in any part of the area of supply of a licensee without the consent of the licensee, unless:

  (i) The actual effective capacity of the licensee's generating station computed in accordance with para IX of the First Schedule at the time when such supply was required was less than twice the maximum demand asked for by any such person; or

  (ii) The maximum demand of the licensee, being a distributing licensee and taking a supply of energy in bulk is, at the time of the request less than twice the maximum demand asked for by any such person; or

  (iii) The licensee is unable or unwilling to supply electricity for such purpose in the said part of such area on reasonable terms and conditions and within a reasonable time.

After the Board has declared its intention to supply electricity for any purpose in any area for which purpose and in which area it is under this section competent to supply electricity, no licensee shall, the provisions of his licence notwithstanding, at any time be entitled without the consent of the Board to supply electricity for the purpose in that area [Section 19 of the Electricity (Supply) Act, 1948]

Power of Board to engage in certain undertakings: The Board may, in accordance with any regulations made in this behalf, manufacture, purchase, sell or let on hire on the execution of a hire-purchase agreement or otherwise, any electric machinery, control-gear, fittings, wires or apparatus for lighting, heating, cooling, or motive power or for any other purpose for which electricity can or may be used, or any industrial or agricultural machinery operated by electricity, and may install, connect, repair, maintain or remove such fittings, wires, apparatus, machinery or control-gear and in respect thereof demand and take such remuneration or rents and charges and make such terms and conditions as it deems fit.

The Board may maintain shops and show-rooms for the display, sale or hire of fittings, wires, apparatus and machinery as aforesaid, conduct displays, exhibitions and demonstrations thereof, and generally do all things, including advertising, incidental to the sale and hire of such fittings, wire, apparatus and machinery and to the promotion and encouragement of the use of electricity.

The Board shall show separately in its accounts moneys received and expended by it in connection with any undertakings in which it engages under this section [Section 20 of the Electricity (Supply) Act, 1948].

1.4 GENERATING COMPANIES

Under Section 15A of the Electricity (Supply) Act, 1948, the Central Government or any State Government or the Central Government and one or more State Governments or two or more State Governments jointly may form a generating company. The current objective of the generating company shall be:

(i) establishing, operating and maintaining generating stations and by lines, sub-stations and main transmission line connected therewith;

(ii) operating and maintaining such generating stations, by-lines, sub-stations and main transmission line as are assigned to it by the Government or Governments forming the generating company.

The Government or Governments forming the generating company may be referred to as promoting company. The generating company carries on its activities within such areas as the promoting Governments may specify from time to time. The promoting Governments form a Board of Directors of the generating company including such number of members as it thinks fit. A full time member of the Board of Directors of a generating company shall be a person who has experience and has shown capacity in,

(a) Design, construction, operation and maintenance of generating stations;

(b) Transmission and supply of electricity;

(c) Applied economics;

(d) Organising workers;

(e) Industrial, commercial and financial matters;

(f) Administration in a Government department or other establishments.

Duties of the generating company:

(a) To establish, operate and maintain such generating stations and by lines, sub-stations and main transmission lines connected therewith as may be required to be established by the promoting Government;

(b) To operate, and maintain in the most efficient and economic manner, by-lines, sub-stations and main transmission lines assigned to it by the promoting Government in co-ordination with the State Electricity Boards;

(c) To carry out detailed investigation and prepare schemes in co-ordination with State Electricity Boards for establishing stations, by-lines, sub-stations and transmission lines connected therewith.

1.5 STATE ELECTRICITY CONSULTATIVE COUNCIL

Under Section 16 of the Electricity (Supply) Act 1948, the State Government shall constitute a State Electricity Consultative Council for the State which consists of the members of the Board and, if there are any generating company or companies operating in the State, one representative of the generating company or each of the generating companies to be nominated by the concerned companies and such other persons being not less than 8 and not more than 15 as the State Government may appoint after consultation with such representative or bodies representative of the following interests as the State Government may think fit. That is to say, local self-Government, electricity supply industry, commerce, industry, transport, agriculture, labour employed in the electricity supply industry and consumers of electricity but so that there shall be atleast one member each of such interest in the Council.

The State Electricity Consultative Council shall meet atleast once in every three months. The functions of the Council shall be as follows :

1. To advise the Board and the generating company on major questions of policy and major schemes;
2. To review the progress and the work of the Board and the generating company operating in the State from time to time.
3. To consider such matters as the Board and the generating company may place before it
4. To consider such matters as the State Government may by rules prescribe.

1.6 LICENSEE AND BULK LICENSEE

Licensee : Under Section 2(6) of the Electricity (Supply) Act, 1948, licensee means a person licensed under Part II of the Indian Electricity Act 1910, to supply energy or a person who has obtained sanction under Section 28 of that Act to engage in the business of supplying energy. Under Section 2(3) of the same Act, *bulk licensee* means a licensee who is authorised by his license to supply electricity to other licensees for distribution by them.

1.7 GRID TARIFF

Under Section 46 of the Electricity Supply Act, 1948, a tariff to be known as grid tariff shall in accordance with any regulations made in this behalf, be fixed from time to time by the State Electricity Board in respect of each area for which a scheme is enforced. Tariffs fixed under this scheme may, if the Board thinks fit, differ for different areas. The State Electricity Board may make such arrangements as may be mutually agreed with any licensee whose area of supply is situated within an area for which a scheme is enforced, in regard to the purchase or sale of electricity and the price thereof, or the purchase, operation or control of any generating station or main transmission line. The Grid Tariff shall apply to sales of electricity by the State Electricity Board to licensees if so required under any of the First, Second and Third Schedules, and shall, also be applicable to sales of Electricity by the Board to licensees in other cases. The Grid Tariff shall be so framed as to include as part of the charge, and shall separately fix kilowatt charges component and running charges component. The fixed kilowatt charges component in the Grid Tariff may be framed as to vary with the magnitude of maximum demand. Where only a portion of the licensee's maximum demand for the purposes of his undertaking are chargeable at the Grid Tariff, the price payable for that Tariff shall not be greater than the average price which would have been payable at the whole of the said maximum demand had the licensee been chargeable at the Grid Tariff.

The Grid Tariff may contain provisions for:

(a) Adjustment of price having regard to the power factor of supply taking or the cost of fuel or both;

(b) A minimum charge related to a past or prospective demand of a licensee on the Board

1.8 INTER-STATE AGREEMENT

The Government of a State may enter into an agreement with the Government of a contiguous State to provide that the Board constituted for the latter State shall exercise the function of a State Electricity Board under the Electricity (Supply) Act in the former State. An agreement under Section 6 of the said Act may:

(a) Make such financial arrangements between the participating State Governments as may be necessary for the purposes of the agreement;

(b) Provide for consultation between the participating State Governments either generally or with reference to particular matters arising under this Act;

(c) Generally make such incidental, supplementary or ancillary provisions, not inconsistent with this Act as may be deemed necessary or expedient for giving effect to the agreement.

Where an agreement is entered into between two or more State Governments, the State Electricity Board constituted for the one State shall have all the powers and duties of a Board under this Act in respect of both the States as if they constitute a single State.

SELF-EXAMINATION QUESTIONS

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. Electricity supply undertakings are governed by
   (a) Indian Electricity Act, 1910
   (b) Electricity (Supply) Act, 1948.
   (c) Both (a) and (b).
   (d) Companies Act 1956.
2. The Grid Tariff may contain provisions for:
   (a) Adjustment of price having regard to the power factor of supply taking or the cost of fuel or both.
   (b) A minimum charge related to a past or prospective demand of a licensee on the Board.
   (c) Adjustment of price for the cost of fuel or both.
   (d) All of the above.
3. Functions of the State Electricity Consultative Council are:
   (a) To review the progress and the work of the Board and the generating company operating in the State from time to time.
   (b) To consider such matters as the Board and the generating company may place before it
   (c) To consider such matters as the State Government may by rules prescribe.
   (d) All of the above.

[**Ans 1** (c); **2** (d); **3** (d)]

II. Short Answer Type Questions

4. Define the terms (*i*) licensee; (*ii*) bulk licensee; (*iii*) Grid Tariff.

III. Long Answer Type Questions

5. Briefly explain the functions of Central Electricity Authority, State Electricity Board and generating companies.

6. Briefly explain the composition of State Electricity Consultative Council and its functions.

UNIT 2 : DOUBLE ACCOUNTS SYSTEM

Learning Objectives

After studying this unit, you will be able to:

- Learn the techniques of preparing financial statements under Double Accounts System.
- Differentiate between replacement and extension or improvement in the accounts. Learn the technique of journalisation of the transactions relating to replacement/extension or improvement of plant and machinery of electricity supply companies.

2.1 INTRODUCTION

"Double Accounts System" is the name given to the system of processing the final accounts of certain statutory companies, formed by special Acts of Parliament, usually public utility undertakings, e.g., electricity companies and railway companies.

The "Double Accounts System" is not a special method of keeping accounts, rather a special method of presenting accounts which are kept under the normal double entry system. Under the system separate accounts in respect of capital and revenue (both receipts and payments) are prepared in order to show clearly the capital receipts and the manner in which the amount thereof has been invested. Such a practice has also the effect of segregating the two types of receipts and payments whereby any deficiency in capital or revenue receipts as compared to the expenditure met out of it, is readily disclosed.

Unless a business is adequately financed *i.e.,* it has sufficient capital to meet its fixed capital expenditure and it is provided with the working capital it requires, it may at any time run into difficulties. Adequacy of capital is more important in the case of a public utility undertaking as compared to others. This is because firstly, a larger amount of capital is usually required to be invested in the form of fixed capital expenditure and secondly, the manner in which the capital has been raised can be quite an important factor for the stability of the concern. For example, if a concern has raised a part of its capital in the form of a bank loan or deposits, it may have to be repaid after some time, which might cause some financial embarrassment to the concern unless some alternative arrangements are made.

It is also important that a public utility concern, once started, should continue to work permanently and should be able to extend its activities so as to meet the growing need of the community. Such a condition can be ensured only if the undertaking appropriates out of its profits a sufficient amount to the credit of the Depreciation Fund accumulated over the life of different assets for their replacement at the end thereof. The extent of accumulation of Depreciation Fund is shown by Statement Vs. Annexure V to the Indian Electricity Rules, 1956.

It must further be added that in the Double Accounts System, as it was originally conceived, a provision for depreciation was not required to be made out of profits, at fixed rate, taking into account the working life of each asset; instead only *ad hoc* provisions were made by appropriating amounts out of revenue to the credit of Depreciation Fund, and the cost of the asset was charged against revenue.

Treatment of capital losses : Under pure Double Accounts System, it is not necessary to write off losses on capital account suffered as a result of abandonment of assets which have run off their normal life and are not to be replaced. Thus assets which are no longer in use or which have no value to the undertaking continue to be shown in the Capital Account at their full original cost.

However, in practice, it is usual to provide for the losses in respect of such assets by making suitable provisions as a charge against profits. These provisions are shown in the General Balance Sheet.

Treatment of replacement : As discussed above, under the Double Accounts System it is not necessary to provide for depreciation on fixed assets. As a result, once an asset appears in the Capital Account at a certain figure its value cannot be reduced, though it may be increased whenever there is an extension or improvement of the asset. When the asset is replaced, the replacement may or may not involve extension or improvement and the treatment in either case will vary as described below :

(a) *Where no extension or improvement is involved* : This actual cost of replacement is debited to Revenue Account and written off, while the asset continues to appear in the Capital Account at the original figure. Where the charge for replacement in a particular year is very heavy, it may distort the result of the year's working. in such a case, it is usual to create in advance a Replacement or Depreciation Fund against which the cost of replacement is charged.

(b) Where extension or improvement is involved : In this case a portion of the total cost, representing the cost of the extension or improvement is capitalised and the balance written off to the Revenue Account. Also, if some, benefit is realised from the sale of scrap, or use of material belonging to the old asset, the value of such benefit is reduced from the amount written off to the Revenue Account. The cost of the extension or improvement to be capitalised, is the difference between the actual amount spent and the amount that would have been spent had the old asset been constructed now.

Illustration 1

The ABC Electricity Company decided to replace some parts of its plant by an improved plant. The plant to be replaced was built in 1995 for Rs. 27,00,000. It is estimated that it would now cost Rs. 40,00,000 to build a new plant of the same size and capacity. The cost of the new plant as per the improved design was Rs. 85,00,000 and, in addition, material belonging to the old plant valued at Rs. 2,75,000 was used in the construction of the new plant. The balance of the plant was sold for Rs. 1,50,000. Compute, the amount to be written off to revenue.

Solution

Amount chargeable to Revenue

		Rs.	Rs.
Estimated current cost of replacing old plant			40,00,000
Less :	Break up value of replacing old plant	1,50,000	
	Value of materials belonging to the plant used in the construction of the new plant	2,75,000	4,25,000
Total			35,75,000
Amount to be capitalised			
Cost of building new plant (cash)		85,00,000	
Add :	Value of materials belonging to the old plant in the construction of new plant	2,75,000	87,75,000
Less :	Estimated current cost of replacing old plant		40,00,000
Total			47,75,000

The accounts will be as under :

Plant Account

	Rs.		Rs.
To Balance b/d	27,00,000	By Balance c/d	74,75,000
To Cost of Construction :			
Cash	45,00,000		
Cost of old materials used	2,75,000		
	74,75,000		74,75,000
To Balance b/d	74,75,000		

Replacement Account

	Rs.		Rs.
To Bank-portion to be written off out of replacement cost	40,00,000	By Bank	1,50,000
		By Plant Account	2,75,000
		By Revenue Account	35,75,000
	40,00,000		40,00,000

Illustration 2

An Electricity Company laid down a Main at a cost of Rs. 16,00,000. Some years later the company laid down an auxiliary Main for one-fourth of the old Main at a cost of Rs. 6,00,000. It also replaced the rest of the length of the old Main at a cost of Rs. 18,00,000 the cost of material and labour having gone up by 15%. Sale of old materials realised Rs. 40,000. Old materials valued at Rs. 40,000 were used in renewal and those valued at Rs. 60,000 were used in auxiliary Main.

Show the Journal Entries for recording the above transactions. Show workings.

Solution

Journal of Electricity Co.

		Rs.	Rs.
Replacement Account	Dr.	13,80,000	
To Bank Account			13,80,000
(Current cost of replacement of 3/4 Main charged to Replacement account)			
New Main Account	Dr.	6,00,000	
To Bank Account			5,40,000
To Replacement Account			60,000
(Cost incurred on laying auxiliary main including old material worth Rs. 60,000)			
New Main Account	Dr.	4,20,000	
To Bank Account			3,80,000
To Replacement Account			40,000
(Additional Cost of New Main capitalised including cost of old material used Rs. 40,000)			

Bank A/c	Dr.	40,000	
To Replacement A/c			40,000
(Sale of old materials)			
Revenue Account	Dr.	12,40,000	
To Replacement A/c			12,40,000
(Net current cost of replacement transferred)			

Working Notes :

Amount of additional cost to be capitalised

	Rs.
Cost of 3/4 of old Main	12,00,000
Add: Increase in cost by 15%	1,80,000
	13,80,000
Cost of replacement	18,00,000
Additional cost of new Main (to be capitalised)	4,20,000
Less: Cost of old material	40,000
Additional cash cost of replacement	3,80,000

Illustration 3

Bijlee Power Supply Co. Ltd., has built a power station and the connecting lines during the year 2004. The following further particulars are furnished to you :

(i) In the year 2004, the company incurred an amount of Rs. 35,78,200 towards purchases of machinery items and Rs. 3,97,500 towards labour expenses. The company also used stores worth Rs. 7,82,300 from its existing stock which was in the godown.

(ii) Extension and replacement was carried out to the power station in the year 2007 at a cost of Rs. 15,20,000, out of which material worth Rs. 30,000 was used from existing stock for replacement purposes. The extent of replacement was estimated at 20% of original cost.

(iii) The cost of materials and wages in 2007 have gone up by 25%.

(iv) The old material discarded in the process of extension and replacement was of the value of Rs. 1,42,000.

(v) Out of the above, material valued at Rs. 75,000 was used for extension purposes and the balance not being used was sold for Rs. 67,000.

You are required to show the journal entries in respect of the above transactions for the year 2004 and 2007. Working should form part of your answer.

Solution

Bijlee Power Supply Co. Ltd.

Journal

			Dr.	*Cr.*
			Rs.	*Rs.*
(i)	2004 New Works A/c	Dr.	47,58,000	
	To Bank			39,75,700
	To Stores			7,82,300
	(Cost of power station & connecting lines - machinery Rs. 35,78,200 labour expenses Rs. 3,97,500 and stores Rs. 7,82,300 capitalised)			
(ii)	2007 New Works A/c	Dr.	3,30,500	
	Replacement A/c	Dr.	11,89,500	
	To Bank			14,90,000
	To Stores			30,000
	(Cost of 20% replacement and extension cost of Rs. 3,30,500 capitalised)			
	Bank A/c	Dr.	67,000	
	New Works A/c	Dr.	75,000	
	To Replacement A/c			1,42,000
	(Cost of old material used in New Works Rs. 75,000 and balance sold for Rs. 67,000)			

It has been assumed that total cost including purchase of Machinery in 2005 has gone up by 25%.

It has been assumed that cost of old material used is not included in Rs. 15,20,000 (cost of new works given in the question.)

Working Notes :

(1)	Current Cost of Replacement :	*Rs.*
	Cost in 2002	47,58,000
	Cost of 20% of plant replaced	9,51,600
	Add: Increase in cost 25%	2,37,900
	Current cost of replacement	11,89,500

Illustration 4

The Gurgaon Electricity Company Limited decides to replace one of its old plants with a modern one with a larger capacity. The plant when installed in 1980 cost the company Rs. 24 lakhs, the components of materials, labour and overheads being in the ratio of 5:3:2. It is ascertained that the costs of materials and labour have gone up by 40% and 80% respectively. The proportion of overheads to total costs is expected to return the same as before.

The cost of the new plant as per improved design is Rs. 60 lakhs and in addition, material recovered from the old plant of a value of Rs. 2,40,000 has been used in the construction of the new plant. The old plant was scrapped and sold for Rs. 7,50,000.

The accounts of the company are maintained under the Double Accounts System. Indicate how much would be capitalised and the amount that would be charged to revenue. Show the ledger accounts.

Solution

Gurgaon Electricity Company Limited

Plant Account

Dr.					*Cr.*
		Rs.			*Rs.*
To	Balance b/d	24,00,000	By	Balance c/d	49,20,000
To	Bank A/c (Cost of new plant capitalised)	22,80,000			
To	Replacement A/c (old parts)	2,40,000			
		49,20,000			49,20,000
To	Balance b/d	49,20,000			

Replacement Account

		Rs.			Rs.
To	Bank A/c (Current cost of replacement)	37,20,000	By	Bank A/c (Sale of scrap)	7,50,000
			By	Plant A/c (old material used)	2,40,000
			By	Revenue A/c (Transfer)	27,30,000
		37,20,000			37,20,000

Working Note :

Cost to be incurred for replacement of present plant

	Cost of Existing Plant	*Increase*	*Current cost*
	Rs.	%	*Rs.*
Materials	12,00,000	40%	16,80,000
Labour	7,20,000	80%	12,96,000
			29,76,000
Overheads (1/4 of above or 1/5 of total)			7,44,000
Current replacement cost			37,20,000
Current replacement cost			37,20,000
Total cash cost			60,00,000
Amount capitalised, excluding old materials used			22,80,000

2.2 GENERAL PRINCIPLES FOR BOARD'S FINANCE

The State Electricity Boards after taking credit for any subventions from the State Governments under Section 63 of the Electricity Supply Act, carry on their operation under this Act and adjust tariffs so as to ensure that the total revenues in any year of account shall after meeting all expenses properly chargeable to revenues, including operating, maintenance and management expenses, tax (if any) on income and profit depreciation and interest payable on all debentures, bonds and loans leave such surplus as is not less than 3% of the value of fixed assets, or such higher percentage as the State Government may decide. For this purpose the value of fixed assets of the Board in service at the beginning of the year are to be considered. Thus it is expected that the Board should fix up Tariff in such a manner as to yield at least 3% return on opening value of fixed assets. For the purposes of this section, the value of fixed assets of the Board in service at the beginning of the year means the original cost of such fixed assets as reduced by the aggregate of the cumulative depreciation in respect of such assets calculated in accordance with the provisions of this Act and consumers' contribution for service lines.

In specifying the surplus to be earned by the Board, the State Government have due regard to the availability of amounts accrued by way of depreciation and the liability for loans, amortisation and leave:

(a) a reasonable sum to contribute towards the cost of capital works; and

(b) where in respect of the Board a notification has been issued, a reasonable sum by way of return on capital provided by the State Government and the amounts of loans converted by the State Governments into capital.

2.3 ANNUAL FINANCIAL STATEMENTS

In February of each year the Board shall submit to the State Government in the prescribed form of the estimated capital and revenue receipts and expenditure for the ensuing year. The said statement shall include a statement of salaries of Members and Officers and every employee of the Board. The State Government shall lay on the table of the House of the State Legislature the said statements. The Board cannot expend a sum costing Rs. 75,000, on account of recurring expenditure or costing Rs. 3,00,000 on account of non recurring expenditure in any year in case of extreme emergency unless such sum has been included in a statement submitted to the State Government. The State Government may with the approval of the State Legislature from time to time make subventions to the Board for the purposes of Board's activities. Also the State Government may from time to time advance loans to the Board for its activities. With the previous sanction of the State Government, the Board may from time to time borrow money for its activities. The State Government may convert any part of its loan advanced to the Board into capital, if it appears to that Government to be reasonable in the circumstances of the case.

2.4 FINAL ACCOUNTS

The Board shall keep proper accounts and other records in relation thereof including a proper system of internal check and prepare annual statements of accounts, including the Profit and Loss Account and the Balance Sheet as per the forms given in the Indian Electricity Rules, 1956. The Indian Electricity Rules provide the forms of accounts.

Annexure IV, Summary of Technical and Financial Particulars;

Annexure V No. 1 Statement of Share and Loan Capital;

Annexure V No. 1A(1) Statement of loans raised and redeemed;

Annexure V No. 1A(2) Statement of loan and other capital;

Annexure V No. II Statement of Capital expenditure;

Annexure V No. 2(A) Statement showing the written-down cost of fixed assets retired on account of obsolescence, inadequacy, superfluity etc.

Annexure V No. III Statement of Operating Revenue :

Annexure V No. IV Statement of Operating Expenses;

Annexure V No. V Statement of Provision for Depreciation;

Annexure V No. VI Statement of Contingencies Reserve;

Annexure V No. VII Statement of Tariffs and Dividends Control Reserve Account;

Annexure V No. VIII Statement of Consumers' Rebate Reserve Account;

Annexure V No. IX Statement of Special Appropriations permitted by State Government.

Annexure V No. X Statement of Net Revenue and Appropriations Account.

Annexure V No. XI General Balance Sheet.

All the forms are given in para 3.5

The accounts of the Board shall be audited by the Comptroller and Auditor General of India or by such person as he may authorise and any expenditure incurred by him in connection with such audit shall be payable by the Board. The Comptroller and Auditor General of India or any person authorised by him in connection with the audits of the accounts of the Boards shall have the same rights, privileges and authority in connection with such audit as the Comptroller and Auditor General of India has in connection with the audit of Government Accounts. The accounts of the Board as certified by the Comptroller and Auditor General of India or any other person authorised by him shall be forwarded to the Central Electricity Authority and to the State Government within six months of the close of the year to which the accounts and audit report relate and that Government may issue such instruction to the Board in respect thereof as it deems fit and the Board shall comply with such instructions.

The State Government shall keep the accounts of the Board together with the audit report thereon and forward to it to be laid annually before the State Legislatures and keep the accounts of the Board to be published in the prescribed manner and make available copies thereto on sale at a reasonable price.

2.5 ANNUAL REPORT AND ACCOUNTS OF GENERATING COMPANY

The Generating company shall before the expiry of 31st December of each year, submit to the promoting Government (s) a report giving an account of the activities if any which are likely to be undertaken by such generating company in the ensuing year together with a statement of the estimated capital and revenue receipts and expenditure for that year in the prescribed form. A generating company shall as soon as may be after the end of each year, prepare a report giving an account of its activities during the previous year and shall within six months of the date of closure of year forward to the promoting Government (s) a report together with a statement of accounts in the prescribed form, a copy of the Balance Sheet and Profit and Loss Account and the Director's Report in relation to the accounts of the year. For the purpose of preparing the statement of account, the depreciation to be provided every year shall be calculated in accordance with the same method as laid down by, or under this Act for calculating depreciation in relation to the Board.

The generating company shall carry on its operation under this Act and adjust its operation so as to ensure that the total revenues in any year of account shall after meeting all the expenses properly chargeable to revenue including operating, maintenance and management expenses, taxes (if any) on income and profits, depreciation and interest payable on all debentures, bonds and loans, leave such surplus as the promoting Government may specify from time to time. In specifying the surplus the promoting Government shall have due regard to the availability of amounts approved by way of depreciation and the liability for loans, amortisation and leave a reasonable amount to contribute towards the cost of capital works and for payment of dividend on shares.

2.6 FORMS OF ACCOUNTS

Annexure IV

Summary of Technical and Financial Particulars for the year ended

31st March, 20..

[See Rule 26(3)]

A TECHNICAL

1. Year of working.
2. Area of supply in square miles.
3. Approximate population in the area of supply.
4. Installed capacity.
   (a) Generating plant (excluding retired plant.)
      (i) Hydralulic kW
      (ii) Steam kW
      (iii) Internal combustion kW
      TotalkW
   (b) Receiving Station.
      Transformers kVA

5. Normal maximum Demand on the system kW

6. kWh generated :

   (i) Hydraulic kWh

   (ii) Steam kWh

   (iii) Internal combustion kWh

   Total kWh

7. kWh used for Generating Station Auxiliaries.

8. kWh purchased from other agencies.

9. kWh available for sale (6 – 7) + 8.

10. kWh supplied free (if any) to officers and staff.

11. kWh supplied free (if any) to offices, canteen etc.

12. kWh sold.

13. kWh unaccounted for [9 – (10+11+12)].

14. Fuel :

    (a) (i) Coal and/or furnace oil consumed in tons.

    (ii) Average calorific value per lb. of coal and or/furnace oil consumed.

    (iii) Average cost of coal and/or furnace oil per ton.

    (b) (i) Oil consumed in tons.

    (ii) Average calorific value per lb. of oil consumed.

    (iii) Average cost of oil per ton.

15. Lubricating oil :

    (a) Quantity consumed (gallons).

    (b) Average cost per gallon.

16. Consumers: No. Connected load kW

    (a) Domestic or residential.

    (b) Commercial.

(c) Industrial:

(i) Low and medium voltage.

(ii) high and/or extra-high voltage.

Total

17. Segregation of kWh sold :

(i) Domestic or residential :

(a) Lights* and Fans.

(b) Heating and small Power.

(ii) Commercial :

(a) Lights* and Fans.

(b) Heating and small Power.

(iii) Industrial Power :

(a) Low and medium voltage.

(b) High voltage.

(iv) Public Lighting.

(v) Traction.

(vi) Irrigation.

(vii) Public Water-works and Sewage Pumping.

(viii) Supplies in bulk to Distributing Licensees.

* Including unmetered supply.

B. FINANCIAL :

1. Share Capital (paid-up).
2. Loan Capital (other than loans advanced by the State Electricity Board).
3. Licensee's Capital (1+2).
4. Total Capital Expenditure.
5. Capital Base [Vide Paragraph XVII (1) of the Sixth Schedule to the Electricity (Supply) Act, 1948].
6. Reasonable Return [vide Paragraph XVII(9) of the Sixth Schedule to the Electricity (Supply) Act, 1948].

7. Clear Profit [Vide Paragraph XVII(2) of the Sixth Schedule to the Electricity (Supply) Act, 1948].
8. Maximum sum permissible for distribution to Share and Debenture holders [Vide Paragraph II(1) of the Sixth Schedule to the Electricity (Supply) Act, 1948].
9. Actual sum available for distribution to share and debenture holders.
10. Item (9) expressed as a % of item (3).
11. Item (9) expressed as a % of item (4).
12. Item (9) expressed as a % item (5).
13. Dividend declared for the year.
    (a) On ordinary shares.
    (b) On preference shares.
14. Market Price of shares.
    (a) Ordinary shares.
    (b) Preference shares.
15. Operating Revenues (Vide Statement III Annexure V).
16. Operating Expenses including depreciation (Vide Statement IV Annexure V).
17. Depreciation set apart for the year (Vide Statement V Annexure V).
18. Revenue per kWh sold (overall) (Item 15 kWh sold.)
19. Revenue per KWh sold :
    (i) Domestic or Residential :
        (a) Lights* and Fans.
        (b) Heating and Small Power.*
    (ii) Commercial :
        (a) Lights* and Fans.
        (b) Heating and Small Power.
    (iii) Industrial Power :
        (a) Low and medium voltage.
        (b) High voltage.

(iv) Public Lighting.

(v) Traction.

(vi) Irrigation.

(vii) Public Water-works and Sewage Pumping.

(viii) Supplies in bulk to Distributing Licensees.

20. Cost per kWh sold (overall) (Item 16 kWh sold.)

*Including unmetered supply.

Annexure V

[See Section 11 and rule 26(3)]

ELECTRIC LICENCE, 20..

Date of Commencement of License

Name of undertaking **Year of Operation**

NO. I STATEMENT OF SHARE AND LOAN CAPITAL
FOR THE YEAR ENDED 31ST MARCH 20..

Applicable to Licencees other than Local Authority Licencees)

Description of Capital	Balance at the beginning of the year	Receipts during the year	Redeemed during the year	Balance at the end of the year	Remarks
1	2	3	4	5	6
A : SHARE CAPITAL					
Authorised Capital					
Ordinary shares of Rs. ..each					
% preference shares of Rs. ..each					
Issued Capital					
Ordinary shares of Rs. ..each					
%Preference shares of Rs. .. each					
Subscribed Capital					
Ordinary shares of Rs. ..each					
%Preference shares of Rs. ..each					

Called-up Capital

Ordinary shares of Rs. ..each

%Preference shares of Rs. ..each

Less calls in arrears.

Paid up Capital

Ordinary shares of Rs. each

%Preference shares of Rs. each

Total Paid up Capital

B : CAPITAL RESERVE.

Share Forfeiture A/c.

Share Premium A/c.

Other items (to the specified)

Total Capital Reserve

C : LOAN CAPITAL

Loans from State Electricity Board

Debentures.

(......% Debentures of Rs. each)

Other secured Loans.

Unsecured loans & advances.

Total Loan Capital

D : OTHER CAPITAL.

Contributions from consumers including local authorities for service-lines and public lighting after the commencement of the Electricity (Supply) Act, 1948.

Special items (to be specified)

Total Other Capital

Total Capital Raised and Appropriated (A+B+C+D).

Note : Capital invested by proprietor, partnership, co-operative society, company etc. licensee which is interest bearing should be shown under 'C-Unsecured loans and advances' and which is interest-free should be shown under 'D - Special items (to be specified)'.

Annexure V

ELECTRIC LICENCE, 20_ _

Date of Commencement of Licence

Name of local Authority : *Year of Operation :*

No. 1A (1) : STATEMENT OF LOANS RAISED AND REDEEMED FOR THE YEAR ENDED 31ST MARCH, 20-

(Applicable to Local Authority Licensees)

Description of loan raised from time to time	Amount sanctio-ned	Rate %	Period of payment From	To	Amount of Annual instalment	Amount of loan redeemed upto the beginning of the year	Amount of loan redeemed during the year	Total redeemed upto the end of the year	Balance loan out-standing at the end of the year	Remarks
1	2	3	4	5	6	7	8	9	10	11

Total Loans Raised For The Electrification Scheme

No. I A (2) Statement of Loan and Other Capital for the Year Ended 31st March 20—

Particulars	Balance at the begin-ning of	Received during the year	Redeemed during the year	Balance at the end of	Remarks

	the year			the year	
1	2	3	4	5	6
A : Capital Raised					
Amount of loans outstanding [as per col. 10 of statement 1-A(1)] Grants and advances made from the general funds of the local authority.					
Grants-in aid from Government.					
Total Capital					
B : Capital Reserve					
Loan redemption account [as per col. 9 of statement I - A(1)].					
Other items (to be specified).					
Total Capital Reserve					
C : Other Capital					
Consumers' contributions for service lines after the commencement of the Electricity (Supply) Act, 1984.					
Special items (to be specified).					
Total Other Capital					
Total Capital Raised and Appropriated (A + B + C)					

No. II Statement of Capital Expenditure

for the year Ended 31st March, 19—

particulars	Balance at the begin-ning of the year	Additions during the year	Retirements during the year vide Col. 3 State-ment II-A.	Balance at the end of the year	Remarks
1	2	3	4	5	6

A : *Intangible Assets.*

1. Preliminary & Promotional expenses.
2. Cost of licence.
3. Other expenses e.g. expenses incidental to conversion from D.C. to A.C., change of frequency etc.

Total Intangible Assets.

B : *Hydraulic Power Plant.*

1. Land & Rights.
2. Buildings and civil engineering works containing generating plant and equipment.
3. Hydraulic works forming part of a hydro-electric system including :
   (i) dams, spillways weirs, canals, reinforced concrete flumes and siphons.
   (ii) reinforced concrete pipe lines, sluice gates, steel surge tanks, hydraulic control valves and other hydraulic works.
4. Water wheels, Generators & ancillary equipment including plant foundations.

5. Switchgear including cable connections.
6. Miscellaneous power plant equipment.
7. Other civil works (to be specified).

   Total Hydraulic Power Plant.

C : *Steam Power Plant*

1. Land & Rights.
2. Buildings and civil engineering works containing generating plant and equipment.
3. Boiler plant and equipment including plant foundations.
4. Engines, Turbines, Generators and ancillary equipment including plant foundations.
5. Water cooling system comprising cooling towers and circulating water systems.
6. Switchgear including cable connections.
7. Miscellaneous power plant and equipment.
8. Other civil works (to be specified).

   Total Steam Power Plant.

D : *Internal Combustion Power Plant.*

1. Land & Rights.
2. Buildings and Civil engineering works containing generating plant and equipment.
3. Engines, Generators and ancillary equipment including plant foundations.
4. Water cooling system comprising cooling towers and circulating water systems.

5. Switchgear including cable connections.

6. Miscellaneous power plant and equipment.

7. Other civil works (to be specified).

   Total Internal Combustion
   Power Plant.

E : Transmission Plant (High or Extra-High Voltage)

1. Land & Rights.

2. Buildings and Structures including civil engineering works containing transmission plant and equipment.

3. Sub-station transformers, transformer kiosks, sub-station equipment and other fixed apparatus including plant foundations :

   (i) transformers including foundations having a rating of 100 kilovolt amperes and over.

   (ii) others.

4. Switchgear including cable connections.

5. Towers, Poles, Fixtures, Overhead conductors and devices :

   (i) lines on steel or reinforced concrete supports operating at nominal voltages higher than 13.2 kilovolts.

   (ii) other lines on steel or reinforced concrete supports.

   (iii) lines on wood supports.

6. (i) Underground cables and devices including joint boxes and disconnecting boxes.

   (ii) Cable duct system.

TOTAL TRANSMISSION PLANT.

F : Distribution Plant — High voltage.

1. Land & Rights.
2. Buildings and Structures including civil engineering works containing distribution plant and equipment.
3. (i) Sub-station transformers, transformer kiosks, sub-station equipment and other fixed apparatus including plant foundations.

   (ii) Others.
4. Switchgear including cable connections.
5. Towers, Poles, Fixtures, Overhead conductors and devices :

   (i) lines on steel or reinforced concrete supports operating, at nominal voltages, higher than 13.2 kilovolts.

   (ii) other lines on steel or reinforced concrete supports.
6. (i) Underground cables and devices including joint boxes and disconnecting boxes.

   (ii) Cable duct system.
7. Service lines.
8. Metering equipment.

TOTAL DISTRIBUTION PLANT (H.V.)

G : Distribution Plant — Medium and low Voltage.

1. Land & Rights.
2. Buildings and structures including civil engineering works containing distribution plant and equipment.

3. Sub-station transformers, transformer kiosks, sub-station equipment and other fixed apparatus including plant foundation

    (i) transformers including foundations having a rating of 100 kilovolt amperes and over.

    (ii) others.

4. Switchgear including cable connections.

5. Towers, Poles, Fixtures, Overhead conductors and devices :

    (i) lines on steel or reinforced concrete supports.

    (ii) lines on wood supports.

6. (i) Underground cables and devices including joint boxes and disconnecting boxes.

    (ii) Cable duct system,

7. Service lines.

8. Metering equipment.

TOTAL DISTRIBUTION (M. & L.V.)

H : Public Lighting.

1. Street & signal lighting systems.

    I. General Equipment.

    (Not allocated to other sub-heads)

    1. Land & Rights.

    2. Buildings and Structures.

    3. Office furniture and equipment.

    4. Transportation equipment.

    5. Laboratory and meter testing equipment.

6. Workshop plant and equipment.
7. Tools and work equipment.
8. Communication equipment.
9. Miscellaneous equipment.

TOTAL GENERAL EQUIPMENT

TOTAL CAPITAL ASSETS IN USE.

Note:

(1) Capital expenditure on items F7 and G7 should include contributions made by consumers towards service line charges.

(2) Where it is not possible to give segregation of capital expenditure in respect of certain items and where high, medium or low voltage distribution lines are carried on same supports, the combined figures for such items may be given.

(3) Retirements during the year referred to in Col. 4 in respect of :

(i) intangible assets relate to amounts written off during the year.

(ii) tangible assets relate to the original cost of assets transferred to the special account, under Paragraph VII of the Sixth Schedule to the Electricity (Supply) Act, 1948.

No. II A Statement Showing the Written-Down Cost of Fixed Assets Retired on account of Obsolescence,Inadequacy, superfluity, etc.

Particulars of the Assets	Written down cost of assets at the beginn-ing of the year	Written down cost of assets retired during the year vide col. 4 St.II less column 8 Statement V	Written down cost of assets sold during the year	Amount realised during the year	Excess of sale proceeds over written down cost transferred to "Contingen-cies Reserve" Account vide col. 4 of Statement VI	Annual instalment written-off during the year vide col. 7 Statement VI	Balance of written-down cost at the end of the year
- 1	2	3	4	5	6	7	8

No. III. Statement of Operating Revenues

For the Year Ended 31st March, 20..

Particulars of revenue	Corresponding amount for the previous year of account	Amount for the year of account
1	2	3

A: Net Revenue by Sale of Electricity For Cash & Credit

1. Domestic or Residential.

(a) Lights and Fans.

(b) Heating and small power.

2. Commercial.

(a) Lights and Fans.

(b) Heating and small power.

3. Industrial.

(a) Low and Medium voltage.

(b) High voltage.

4. Public Lighting

5. Public Water-works & Sewage pumping.

6. Irrigation.

7. Traction.

8. Supplies in Bulk to distributing licensees.

Total Revenue by sale of electricity.

B: Miscellaneous Revenue From Consumers :

1. Rentals from.

(a) Meters.

(b) Electric motors, fittings, appliances and other apparatus hired to consumers.

2. Service connection fees.
3. Public Lighting Maintenance.

Total Miscellaneous Revenue from consumers.

C: other Revenues.

1. Sale of stores.
2. Repair of lamps and other apparatus.
3. Commission for the collection of electricity duty.
4. Other miscellaneous items (to be specified.)

Total other Revenues.

TOTAL OPERATING REVENUES.

Deduct

Total Operating Expenses as per St. IV.

Net surplus or deficit carried to the Net Revenue & Appropriations A/c-St. X.

No. IV Statement of Operating Expenses for the Year Ended 31st March, 20—

Particulars of expenses	Corresponding-amount for the previous year of account	Amount for the year of account	Remarks
1	2	3	4
A. HYDRAULIC POWER GENERATION.			
(a) Operation.			
1. Water for power,			
2. Lubricants & other consumable stores.			
3. Station supplies and miscellaneous expenses.			
4. Proportion of salaries, allowances, gratuities, etc., of Engineers, Superintendents, Officers, Supervisory and other staff.			
5. Wages and gratuities to labour.			
6. Contributions to Provident Fund or Staff Pension.			
Total Operation.			

(b) Maintenance.

1. Salaries for supervisory staff.
2. Buildings and civil engineering works containing generating plant & equipment.
3. Hydraulic works forming part of a hydroelectric system, including :
   (i) dams, spillways, weirs, canals, reinforced concrete flumes & siphons.
   (ii) reinforced concrete pipe-lines, and surge tanks, steel pipelines, sluice gates, steel surge tanks, hydraulic works.
4. Water wheels, generators and ancillary equipment including plant foundations.
5. Switchgear including cable connections.
6. Miscellaneous power plant equipment.
7. Other civil works (to be specified).
8. Contributions to Provident Fund or Staff Pension.

Total Maintenance.

(c) Depreciation on Hydraulic Power Generating Plant & Equipment (from Statement V)

TOTAL HYDRAULIC POWER GENERATION EXPENSES :

B- STEAM POWER GENERATION.

(a) Operation.

1. Fuel (excluding sale proceeds of steam, ashes etc.)
2. Lubricants and other consumable stores
3. Water (if purchased separately).
4. Station supplies and miscellaneous expenses.
5. Proportion of salaries, allowances,

gratuities, etc., of Engineers, Superintendents, Officers, supervisory and other staff.

6. Wages and gratuities to labour.
7. Contributions to Provident Fund or Staff Pension.

Total Operations.

(b) Maintenance.

1. Salaries for supervisory staff.
2. Building and civil engineering works containing generating plant & equipment.
3. Boiler plant and equipment including plant foundations.
4. Engines, turbines, generators and ancillary equipment including plant foundations.
5. Water cooling system comprising cooling towers and circulating water systems.
6. Switchgear including cable connections.
7. Miscellaneous power plant and equipment.
8. Other Civil works (to be specified.)
9. Contributions to Provident Fund or Staff Pension.

Total Maintenance.

(c) Depreciation.

Depreciation on Steam Power Generating Plant & Equipment (from Statement V).

TOTAL STEAM POWER GENERATION EXPENSES

C. INTERNAL COMBUSTION POWER GENERATION.

(a) Operation.

1. Fuel

2. Lubricants & other consumable stores
3. Water (if purchased separately).
4. Station supplies and miscellaneous expenses.
5. Proportion of salaries, allowances, gratuities, etc. of Engineers, Superintendents, Officers, supervisory and other staff.
6. Wages and gratuities to labour.
7. Contributions to Provident Fund or Staff Pension.

Total Operation

(b) Maintenance.

1. Salaries for supervisory staff.
2. Buildings and civil engineering works containing generating plant & equipment.
3. Engines, generators and ancillary equipment including plant foundations.
4. Water cooling system comprising cooling towers & circulating water systems.
5. Switchgear including cable connections.
6. Miscellaneous power plant and equipment.
7. Other civil works (to be specified).
8. Contributions to Provident Fund or Staff Pension.

Total Maintenance.

(c) Depreciation.

Depreciation on Internal
Combustion Power Generating
Plant & Equipment (from Statement V)

TOTAL INTERNAL COMBUSTION POWER

GENERATION EXPENSES.

D. POWER PURCHASED :

TOTAL PRODUCTION EXPENSES A+ B + C + D

E. TRANSMISSION (HIGH OR EXTRA-HIGH VOLTAGE).

(a) Operation and Maintenance.

1. Proportion of salaries, allowances, gratuities, etc., of Engineers, Superintendents, Officers, supervisory and other staff.
2. Wages & gratuities to sub-station labour.
3. Wages & gratuities to labour on lines
4. Buildings and structures including civil engineering works containing transmission plant and equipment.
5. Sub-station transformer, transformer kiosks, sub-station equipment and other fixed apparatus including plant foundations.
   (i) Transformers including foundations having a rating of 100 kilovolt amperes and over.
   (ii) Others.
6. Switchgear including cable connections.
7. Towers, Poles, Fixtures, Overhead conductors and devices
   (i) Lines on steel or reinforced concrete supports operating at nominal voltages, higher

than 13.2 kilovolts.

(ii) Other lines on steel or reinforced concrete supports.

(iii) Lines on wood supports.

8. (i) Underground cables and devices including joint boxes and disconnecting boxes.

(ii) Cable duct system.

9. Contributions to Provident Fund or Staff Pension.

(b) Depreciation on Transmission Plant & Equipment (from Statement V).

TOTAL TRANSMISSION EXPENSES.

F. DISTRIBUTION (HIGH VOLTAGE)

(a) Operation and Maintenance.

1. Proportion of salaries, allowances, gratuities, etc., of Engineers, Superintendents, Officers, Supervisory and other staff.

2. Wages & gratuities to sub-station labour.

3. Wages and gratuities to labour for mains.

4. Buildings and structures including civil engineering works containing distribution Plant equipment.

5. Sub-station transformers, transformer kiosks, sub-station equipment and other fixed apparatus including plant foundations.

(i) Transformers including foundations having a rating of 100 kilovolt amperes and over.

(ii) Others.

6. Switchgear including cable connections.

7. Towers, Poles, Fixtures, Overhead conductors and devices.

   (i) Lines on steel or reinforced concrete supports operating at nominal voltages, higher than 13.2 kilovolts.

   (ii) Other lines on steel or reinforced concrete supports.

   (iii) Lines on wood supports.

8. (i) Underground cables and devices including joint boxes and disconnecting boxes.

   (ii) Cable duct system

9. Service lines.

10. Metering Equipment.

11. (a) Contributions to Provident Fund or Staff Pension.

    (b) Depreciation on Distribution plant and Equipment (from Statement V).

Total Distribution (H.V) Expenses.

G. DISTRIBUTION (MEDIUM AND LOW VOLTAGE).

(a) Operation and Maintenance.

1. Proportion of salaries, allowances, gratuities, etc. of Engineers, Superintendents, Officers, Supervisory * other staff.

2. Wages & Gratuities to labour.

3. Buildings & structures including civil engineering works containing transmission plant and equipment.
4. Sub-station transformer kiosks, sub-station equipment and other fixed apparatus including plant foundations.
   (i) Transformers including foundations having rating of 100 kilovolt amperes and over.
   (ii) Others.
5. Switchgear including cable connections.
6. Towers, Poles, Fixtures, Overhead conductors and devices.
   (i) lines on steel or reinforced concrete supports.
   (ii) Lines on wood supports.
7. (i) Underground cables and devices including joint boxes and disconnecting boxes.
   (ii) Cable duct system.
8. Service lines.
9. Metering equipment.
10. (a) Contribution to Provident Fund or Staff Pension.
    (b) Depreciation on Distribution Plant and Equipment (from Statement V).

Total Distribution (M. & L.V.) Expenses.

H. PUBLIC LIGHTING

(a) Operation and Maintenance.

1. Operation & Maintenance.
2. Renewal of lamps.

(b) Depreciation on P.L. system & equipment (from Statement V).

Total Public Lighting Expenses.

CONSUMERS' SERVICING, METER READING BILLING, COLLECTING, ACCOUNTING, SALES PROMOTING ETC.

1. Proportion of salaries, allowances, gratuities etc. of Engineers, Secretary, Accountants, other officers, etc.
2. Meter reading and inspection.
3. Billing, Collecting and accounting.
4. Exhibitions, Demonstrations and advertisements.
5. Merchandising, servicing and contract work.
6. Miscellaneous expenses.
7. Contributions to Provident Fund or Staff Pension.
8. Depreciation on general assets and equipment, which are not allocated to other sub-heads, (from Statement v).

TOTAL CONSUMERS' SERVICING,

METER-READING ETC.

K. GENERAL ESTABLISHMENT CHARGES

1. Proportion of salaries, allowances, gratuities etc. of general officers, executives etc.
2. Salaries, wages, gratuities etc. of general office staff.

3. Contributions to local authority administration for supervision (applicable to local authority licencee only).
4. Travelling and other expenses of officers and staff.
5. Rents and Wayleaves.
6. Rates and Taxes.
7. General Office expenses and show-room maintenance and supplies.
8. Office buildings, staff quarters, furniture and fixtures, office equipment etc., and maintenance.
9. Depreciation on office and general buildings, furniture etc. not allocated to other sub-heads. (from Statement V).
10. Audit services :
    (a) Auditor of company.
    (b) Auditor appointed under the provisions of the Act.
11. Legal services.
12. Insurance expenses.
13. Contributions to Provident Fund or Staff Pension.

Total General Establishment Charges.

L. OTHER CHARGES

1. Interest paid and accrued on :
    (a) Loans advanced by State Electricity Board.
    (b) Depreciation fund.
    (c) Consumers' security deposits.

2. Bad Debts written off.

3. Other items (to be specified).

Total other charges.

M. MANAGEMENT EXPENSES.

1. Directors' Fees and expenses
 and Debenture Trustees fees. If any.

2. Managing Agents' ordinary remuneration.

3. Managing Agents' office allowances.

Total Management Expenses.

TOTAL OPERATING EXPENSES
TRANSFERRED TO STATEMENT III.

Notes:

(1) No apportionment of expenses under sub-head 'M' be made to any of the salary items under A—(*a*) 4, B—(a)5 c—(a)5, E—(a)1, F—(a)1, G—(a) 1, J—1 and K—1 which shall include the proportion of salaries and allowances of persons solely employed for the purpose of the undertaking and of the engineering staff employed by the Managing Agents under the Provision of sub-para (3) of Para XIII of the Sixth Schedule to the E(S) Act, 1948

(2) Managing Agents in this context refer to the Managing Agents appointed under Section 87 of the Indian Companies (Amendment) Act, 1936.

No. V. - Statement of Provision for Depreciation
For the Year Ended 31st March, 20. . . .

Additions during the year

Description	Balance	Balance	Interest 4%	@ Depreciation	Arrears	Total	Withdrawals	Balance	Balance
of assets	of accrued	of arrears	per on	annum provided	of dep-		during the	of accr-	of arrears
in groups	Depreciation	of Dep-	the balance	for the	reciation		year, vide	ued dep-	of depre-
as per	brought for-	reciation	at begin-	the year	written		column 3	riciation	ciation

Statement II	ward from last account	brought for- ward from last account	ing of the Sixth Sche- dule to the Electricity (Supply) Act, 1948		off during the year		Statement II-A	carried over to next acc- ount	carried over to next account	Remarks
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)

A. Hydraulic Power Plant ....
....

B. Steam Power Plant

C. Internal Combustion
Power Plant.

D. Transmission Plant High
or Extra High Voltage.

E. Distribution Plant—High
Voltage.

F. Distribution Plant—Medium and
Low Voltage.

G. Public Lighting

H. General Equipment

TOTAL

Note : 1.Withdrawals from the depreciation account are permissible only to the extent of past provisions made in respect of assets withdrawn from use and transferred during the year to the special account under Paragraph VII of the Sixth Schedule to the E(S) Act, 1984.

2. A sum of Rs........from the accruals in the depreciation account has been invested in pursuance of the provisions of Paragraph XVII (I)(d) of the Sixth Schedule to the E(S) Act, 1984.

NO. VI - STATEMENT OF CONTINGENCIES RESERVE FOR THE YEAR

ENDED 31ST MARCH 20—

Additions during the year								Withdrawals during the year		
Particulars	Balance at the begin-ning of the year	Appropri-ation during the year	Additions under para-graph IX of the Sixth Schedule of the elec-tric(Supply) Act, 1948 vide Col. 6 statement II-A	Total	Instalment under sub-para (3) of paragraph VII of the Sixth Sche-dule of the Electric (Supply) Act, 1948 vide Co. 7 Statement II-A.	Expenses and/or compenstion under para-graph V of the Sixth Schedule to the Ele-tric (Supply) Act, 1948	Total	Balance at the end of the year	Remarks	
1	2	3	4	5	6	6	7	8	9	10

Note : (1) A sum of Rs.......from the balance of the Contingencies Reserve has been invested under the provisions of paragraph IV

(2) of the Sixth Schedule to the Electricity (Supply) Act, 1948.

No. VII - Statement of Tariffs and Dividends Control Reserve Account for the Year ended 31st March, 20—

Particulars	Balance at the Beginning of the year	Appropriated during the year	Withdrawn during the year (Purpose to be indicated in the Remarks Column)	Balance at the end of the year	Remarks
(1)	(2)	(3)	(4)	(5)	(6)

No. VIII - Statement of Consumers' Rebate Reserve Account for the Year Ended 31st March, 20—

Particulars	Balance at the	Distributed to consumers beginning of the year	Appropriated during the during the	Balance at end of the year	Remarks
1	2	3	4	5	6

NO. IX. STATEMENT OF SPECIAL APPROPRIATIONS PERMITTED BY STATE GOVERNMENT

Particulars giving reference to the sanction of the State Government permitting the appropriation	Balance at the beginning of the year	Additions by way of appropriation during the year	Transfers by way of reappropriation during the year details to be given in the remarks column	Balance at the end of the year	Remarks
1	2	3	4	5	6

No. X Statement of net Revenue and Appropriations Account for the Year Ended 31st March, 20—

Corresponding figures of previous year	Particulars	Amount	Corresponding figures of previous year	Particulars	Amount
1	2	3	4	5	6
	1. To Balance of loss brought forward from last account.			1. By Balance of profit brought forward from last account.	
	2. To net operating deficit as per Statement III			2. By net operating surplus as per Statement III	
	3. To appropriations (applicable to Local Authority Licencee only):			3. By interest on securities and investments.	
	(*a*) Interest on loan capital.				
	(*b*) Instalment of redemption of				

loan capital as per col 8 of St IA(1).

(*c*) General rates.

4. To taxes on income and profits paid.
5. To instalment of write-down in respect of intangible assets.
6. To instalment of contribution towards areas of depreciation, as per Statement V-Column 6.
7. To contribution towards Contingencies Reserve as per Statement VI-Column 3.
8. To appropriation to Tariffs and Dividends Control Reserve, as per Statement VII - Column 3.
9. To appropriation to Consumers' Rebate Reserve, as per Statement VIII-Column 3.
10. To other special appropriation permitted by the State Government, as per Statement IX-Column. 3.
11. To appropriation towards interest paid and accrued and dividends paid and payable:
    (*a*) Interest on debentures.
    (*b*) Interest on other secured loans.
    (*c*) Interest on unsecured loans, advances, deposits, bank overdrafts etc.
    (*d*) Dividends on preference share capital.
    (*e*) Dividends on ordinary share capital.

To balance of profit carried over.

4. By other receipts (non-operating) *e.g.* rents :
   Less outgoings not otherwise provided for transfer fee etc. (to be specified).

5. By Balance of loss carried over.

No. XI. General Balance Sheet as on 31st March, 20....

Corresponding figures of previous year	Particulars	Amount	Corresponding figures of previous year	Particulars	Amount
1	2	3	4	5	6
	1. Capital raised and appropriated-vide Statement I or I-A.			1. Capital amount expended on Works in use - Statement II.	
	Reserves and Surplus			Less: Accumulated provisions for	
	2. Non-statutory Reserve.			depreciation. Statement V.	
	3. Contingencies Reserve Fund as per Statement VI.			**Net Block**	
	4. Tariffs & Dividends Control Reserve as per Statement VII.			2. Balance of written down cost of obsolete, inadequate etc., assets, Statement II A.	
	5. Consumers' Rebate Reserve as per Statement VIII.			**Current Assets**	
	6. Special appropriations (as Permitted by the State Government) reserve as per Statement IX.			3. Capital works in progress.	
				4. Stores and materials in hand :	
				(*a*) Fuel-Coal and/or oil etc. at cost	
	7. Balance of Net Revenue and Appropriations Account as per Statement X.			(*b*) General Stores at or below cost	
				5. Debtors for amounts paid in advance on account of contracts.	
	Current Liabilities and Provisions at cost.			6. Sundry debtors for electricity supplied	
				7. Other debtors (as per schedule attached,	
	8. Balances due on construction of Plant, Machinery, etc.			8. Accounts receivable (to be specified)	
				9. Investments in statutory securities at cost	
	9. Creditors on open accounts (as per schedule attached).			(*a*) Contingencies Reserve Fund investment, (Market value on closing date).	
	10. Consumers' security deposits.			(*b*) Depreciation Reserve Fund investment.	

11. Accounts payable (to be specified).

12. Temporary accommodations, Bank overdrafts and other finances.

13. Other current and accrued liabilities (to be specified).

14. Contingent liabilities and outstanding commitments, if any, to be stated on the face of this Balance Sheet.

(Market value on closing date).

(*c*) Other investments (Market value on closing date)

10. Special deposits.
   (*a*) In respect of taxation.
   (*b*) Others (to be specified).

11. Balance at Bank..
   (*a*) Deposit Account.
   (*b*) Current account and at Call.

12. Cash in hand.

Debit Balances

13. Net Revenue and Appropriations Account Balance at debit thereof– Statement X.

14. Deferred payments.

References

The Electricity (Supply) Act, 1948

The Indian Electricity Rules, 1956

Self-Examination Questions

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. The essential feature of the double accounts system is
   (a) Followed by the public utility concerns.
   (b) Presentation of capital receipts and capital expenditures in a separate account.
   (c) It is a special method of presenting accounts kept under double entry system rather than special method of keeping the accounts.
   (d) All of the above.

2. Power Electric Company decides to replace one of its old plant by an improved plant with larger capacity. The cost of the new plant is Rs. 16,00,000. Materials and Labour earlier and now are in the ratio of 4 : 6.Original cost of the old plant is Rs. 3,00,000. Materials cost has gone up by 2½ times and Labour cost by 3 times since then. Old materials worth Rs. 10,000 were used in the construction of the new plant and Rs. 20,000 were realised from the sale of old materials.

   Current cost of replacing the old plant will be

   (a) Rs. 8,40,000.

   (b) Rs. 7,70,000.

   (c) Rs. 16,10,000.

   (d) Rs.16,00,000.

3. On replacement of an asset, amount realized from sale of old material is credited to

   (a) Asset account.

   (b) Revenue account.

   (c) Replacement account.

   (d) Profit and loss account

4. Original cost of an asset is Rs. 1,00,000. Present cost of its replacement is Rs. 1,30,000. The amount spent in its replacement is Rs. 1,52,0000. The amount to be capitalized will be

   (a) Rs. 22,000.

   (b) Rs. 1,52,000.

   (c) Rs. 1,40,000.

   (d) Rs. 1,30,000

   [Answer 1 (d); 2(a); **3** (c); **4**(a);]

II. Short Answer Type Questions

5. Write short note on main features of double accounts system of presentation of financial information in the case of public utility concern.

III. Long Answer Type Questions

6. Briefly explain the general principles of finance, audit and forms of financial statements of State Electricity Board.

7. Make a critical assessment of the structure of financial statements of an Electricity Supply Company.

IV. Practical Questions

8. An Electricity Company laid down a Main at a cost of Rs. 20,00,000. After 5 years the company laid down an Auxiliary Main for 1/5th of the old Main at a cost of Rs. 8,00,000. It also replaced the rest of the old Main at a cost of Rs. 28,00,000. Old material valued Rs. 2,00,000 were used in renewals and those valued at Rs. 1,50,000 were used in Auxiliary Main. Journalise the above transactions.

9. Electric Supply Ltd. rebuilt and re-equipped one of their Mains at a Cash Cost of Rs. 40,00,000. The old Mains thus superseded cost Rs. 15,00,000. The capacity of the new Main is double that of the old Main.

   Rs. 70,000 was realised from sale of old materials. Four old motors valued at Rs. 2,00,000 salvaged from the old Main were used in the reconstruction. The cost of Labour and Materials is respectively 30% and 25% higher now than when the old Main was built. The proportion of Labour to Materials in the Main then and now is 2 : 3.

   Show the Journal entries for recording the above transactions, if accounts are maintained under Double Account System.

UNIT-3: ACCOUNTING TERMS RELATING TO ELECTRICITY COMPANIES AND FINAL ACCOUNTS

Learning objectives

After studying this unit, you will be able to:

- Understand the meaning of the terms reasonable return, clear profit in the context of Electricity Supply Undertakings and learn the technique of disposal of surplus.
- Learn the technique of preparation of accounts of electricity companies in the formats given in Unit 3 regarding preparation of Receipts and Expenditure on Capital Account, Revenue Account, Net Revenue Account and General Balance Sheet. Learn the techniques of preparing such accounts.

3.1 INTRODUCTION

In this unit we have explained a few important accounting terms relevant to Electricity Supply Companies, techniques of determining reasonable return and surplus, and finalisation of accounts.

3.2 DEPRECIATION

Two methods of depreciation are recognised under para VI of the Sixth Schedule. Either such a sum as will, together with compound interest at the rate of 4% per annum, amount to 90% of the cost of the assets concerned within the life of the assets (as laid down in the Seventh Schedule) has to be set aside as depreciation every year. In such a case the balance in the Depreciation Reserve must be credited with interest @ 4%. The interest will be treated as an expense. Or, the amount of depreciation will be determined by dividing 90% of the cost of the asset by its life.

Depreciation Reserve has to be invested in the undertaking itself.

No depreciation is to be written off when an asset has been written down to 10 per cent of original cost. Also when an asset ceases to be available for use due to obsolescence, inadequacy, superfluity or any other reason, no depreciation is written off. A description regarding non-availability for use is to be made in the books of the undertaking. When a fixed asset is discarded the written down value of the asset is to be charged to Contingencies Reserve, which should be credited with any amount realised by sale or disposal of the assets. If the balance in the Contingencies Reserve is not sufficient to absorb the written down cost of the discarded asset, the unabsorbed amount will form part of the "Capital Base" for determining reasonable return.

3.3 REASONABLE RETURN

The law seeks to prevent an electricity undertaking from earning too high a profit. For this purpose, “reasonable return” has been defined as consisting of :

(a) an yield at the standard rate which is Reserve Bank rate plus two per cent on the capital base as defined below;

(b) Income derived from investment except investment made against Contingencies Reserve;

(c) An amount equal to 1/2 per cent on loans advanced by the Electricity Board;

(d) An amount equal to 1/2% on the amounts borrowed from organisations or institutions approved by the State Government;

(e) An amount equal to 1/2% on the amount raised by the issue of debentures,

(f) an amount equal to 1/2% on balance of Development Reserve and

(g) Such other amounts as may be allowed by the Central Government having regard to the prevailing tax structure in the country.

“Capital Base” means :

(a) the original cost of fixed assets available for use and necessary for the purpose of the undertaking subject to provisions of Paragraph XII in respect of service lines, and the excess amount referred to in the provision to sub-paragraph (2) of paragraph VII in respect of any fixed asset which has ceased to be available for use :

(b) the cost of intangible assets :

(c) the original cost of work in progress;

(d) the amount of investments compulsorily made under paragraph IV, of the Sixth Schedule (contingencies reserve) together with the amount of such investment made after the commencement of the Act from contributions towards depreciation as in the opinion of the Central Electricity Authority could not be utilised for the purpose of the business of the electricity of the undertaking.

(e) an amount on account of working capital equal to the sum of :

   (i) one twelfth of the sum of the book cost of stores, materials and supplies including fuel on hand at the end of each month of the year of account; and

   (ii) one twelfth of the sum of cash and bank balances and call and short-term deposit at the end of each month of the year of account, not exceeding in the aggregate an amount equal to one quarter of the expenditure (listed on the next page);

Less :

(i) the amount written off or set aside on account of depreciation of fixed assets and amounts written off in respect of intangible assets in the books of the undertaking before or after the commencement of the Act;

(ii) the amount of any loans advanced by the Board;

(iii) the amount of any loans borrowed from organisations or institutions approved by the State Government;

(iv) the amount any debentures issued by the licensee;

(v) the amount of security deposits held in cash;

(vi) the amount standing to the credit of the Tariffs and Dividends Control Reserve;

(vii) the amount set apart for the development reserve; and

(viii) the amount carried forward in the accounts of the licencee for distribution to the consumers under paragraph II (see disposal of surplus over reasonable (return),

CLEAR PROFIT: Means the difference between the amount of income and the sum of expenditure plus specific appropriations, made up in each case as follows :

(a) Income derived from :

- (i) gross receipts from sale of energy, less discounts applicable thereto;
- (ii) rental of meters and other apparatus hired to consumers;
- (iii) sale and repairs of lamps and apparatus;
- (iv) rents, less outgoing not otherwise provided for;
- (v) transfer fees;
- (vi) interest on investments, fixed and call deposits and bank balances;
- (vii) other general receipts accountable for the assessment of the Indian income tax and arising from and ancillary or incidental to the business of electricity supply;

(b) expenditure properly incurred on :

- (i) generation and purchase of energy;
- (ii) distribution and sale of energy;
- (iii) rents, rates and taxes, other than taxes on income and profit;
- (iv) interest on loan advanced to the Board;
- (v) interest on loan taken from organisations or institutions approved by the State Government;

(vi) interest on debentures issued by the licencee;

(vii) interest on security deposits;

(viii) legal charges;

(ix) bad debts;

(x) auditor's fees;

(xi) management remuneration as provided for in para XIII;

(xii) depreciation (computed as herein before set out);

(xiii) other expenses (excluding interest on debentures and loans admissible under the law for the time being in force in the assessment of Indian Income tax and arising from and ancillary or incidental to the business of electricity supply;

(xiv) contribution to Provident Fund, staff pension, gratuity and apprentice and other training schemes; and

(xv) bonus paid to the employees of the undertaking :

(a) where any dispute regarding such bonus has been referred to any Tribunal or other authority under any law for the time being in force relating to industrial or labour disputes in accordance with the decision of such Tribunal or authority;

(b) in any other case, with the approval of the State Government;

(c) Special appropriation sufficient to cover :

(i) previous losses (that is to say excess of expenditure over income) which have arisen from the business of electricity supply to the extent in any year permitted by the State Government;

(ii) all taxes on income and profits;

(iii) instalments of written down amounts in respect of intangible assets and new capital issue expenses to the extent in any year actually appropriated for the purpose in the books of the undertaking; provided that the amounts so appropriated shall not exceed the amount found by dividing the written down cost of such assets by the number of complete years remaining before the next option of purchase under the licence arises;

(iv) contributions to the Contingencies Reserve computed (as hereinafter set out);

(v) contributions towards arrears of depreciation;

(vi) contribution to Development Reserve; and

(vii) other special appropriations permitted by the State Government.

3.4 DISPOSAL OF SURPLUS

Should the clear profit exceed the reasonable return, the surplus upto 20% of the reasonable return has to be disposed off as under:

(a) one-third of the surplus, not exceeding 5% of the reasonable return, will be at the disposal of the undertaking;

(b) of the balance, one-half will be transferred to Tariffs and Dividends Control Reserve; and

(c) the balance will be distributed among consumers by way of reduction of rates or special rebate.

An electricity undertaking must so adjust its rates that the amount of clear profit in any year does not exceed the reasonable return by more than 20% of the reasonable return.

Tariffs and Dividend Control Reserve can be utilised whenever the clear profit is less than the reasonable return. The balance in the Reserve must be handed over to the purchaser of the undertaking if it changes hands.

Illustration 1

The following balances have been extracted from the books of an electricity company at the end of 2007 :

	Rs.
Share Capital	1,00,00,000
Reserve Fund (invested in 4 ½% Government Securities at par)	50,00,000
Contingencies Reserve investment in 5% State Loan	10,00,000
Loan from State Electricity Board	40,00,000
8% Debentures	20,00,000
Development Reserve	10,00,000
Fixed assets	2,00,00,000
Depreciation Reserve on Fixed Assets	50,00,000
Consumers' deposits	55,00,000
Amounts contributed by consumers for fixed assets	1,00,000
Intangible assets	5,00,000

Tariffs & Dividend Control Reserve	5,00,000
Current assets (monthly average)	20,00,000

The company earns a profit of Rs. 8,50,000 (after tax) in 2005. Show how the profit is to be dealt with by company, assuming Bank Rate is 5%.

Solution

Capital Base :			*Rs.*
Fixed Assets			2,00,00,000
Intangible assets			5,00,000
Current assets (assuming these include only stores, cash, etc.)			20,00,000
Investment against Contingencies Reserve			10,00,000
		Rs.	2,35,00,000
Less :	Depreciation Reserve	50,00,000	
	Loan from State Elect. Board	40,00,000	
	Debentures	20,00,000	
	Development Reserve	10,00,000	
	Consumers' Deposits	55,00,000	
	Amount contributed by consumers	1,00,000	
	Tariffs & Dividend Control reserve	5,00,000	1,81,00,000
Capital Base			54,00,000
Reasonable Return :			
7% (i.e., Reserve Bank rate 5% + 2%)			
on Rs. 54,00,000 4 ½% on Reserve		3,78,000	
Fund investment		2,25,000	
1/2% on E.B. Loan, Debenture and			
Development Reserve		35,000	
		6,38,000	

The maximum profit allowed for the company is Rs. 6,38,000 + 20% of Rs. 6,38,000, *i.e.*, Rs. 7,65,600

The company has earned Rs. 8,50,000; it must immediately refund to the consumers, the excess, Rs. 84,400 otherwise it will be contravening the provisions of the Electricity (Supply) Act of 1948.

Of Rs. 7,65,000, the disposition will be:

(i) Rs. 6,69,900* will remain at the disposal of the company.

(ii) Rs. 47,850 will be returned to Tariff & Dividend Control Reserve; and

(iii) Rs. 47,850 will be returned to consumers either by a reduction in rates or otherwise.

* Rs. 6,38,000 plus 5% of Rs. 6,38,000: 1/3 of the surplus is more than the 5%.

Illustration 2

From the following information and details relating to the year ended 31st March, 2008 and bearing in mind the provisions of the Electricity (Supply) Act, 1948 indicate the disposal of profit of E.E.C. Limited :

	Rs.
Net Profit before charging debenture interest	19,10,100
Fixed Assets (at cost)	2,10,00,000
Depreciation written off on Fixed assets	49,00,000
Loan from Electricity Board	60,00,000
6% Investments of the Reserve fund	45,00,000
6% Investment of the Contingencies Reserve	38,00,000
Tariffs and Dividends Control reserve	4,20,000
Security Deposit of Customers	2,42,000
Customer's contribution of Main lines	1,60,000
Preliminary expenses	70,000
Average of Current assets	23,70,000
Development reserve	2,20,000
10% debenture Interest paid in the year	7,50,000

Assume Reserve Bank of India rate is 8%

Solution

EEC Limited

Statement showing disposal of profit for the year ended 31st March, 2008

Capital Base :		*Rs.*
Value of Fixed Assets as reduced by Customers' contribution		2,08,40,000
Preliminary expenses		70,000
Average of Current Assets		23,70,000
Investment of the Contingencies Reserve		38,00,000
		2,70,80,000
Deduct : Depreciation on Fixed assets	49,00,000	

Loan from Electricity Board	60,00,000	
Debentures	75,00,000	
Tariffs and Dividends Control Reserve	4,20,000	
Security deposits	2,42,000	
Development reserve	2,20,000	1,92,82,000
Capital Base		77,98,000

Reasonable Return :	Rs.
10% (Bank rate 8% + 2%) on capital base	7,79,800
1/2% on loan from Electricity Board	30,000
1/2% on development reserve	1,100
1/2% on debentures	37,500
Income from Reserve fund Investments	2,70,000
	11,18,400

Surplus and its disposal

Profit	19,10,100
Less: Debenture interest	7,50,000
	11,60,100
Less: Reasonable return	11,18,400
Surplus	41,700
Disposal	
1/3 (being less than 5% of reasonable return) at the disposal of the company	13,900
Of the balance 1/2 to Tariffs and Dividends Control Reserve	13,900
1/2 to consumers for credit to Customers' Benefit A/c	13,900
	41,700

Illustration 3

The following balances have been extracted, at the end of 2007 from the books of an Electricity company :

	Rs.		*Rs.*
Share capital	1,00,00,000	Consumers' Deposits	40,00,000
Reserve Fund (invested in 8% Government securities - at par)	60,00,000	Amount contributed by consumers towards cost of fixed assets	2,00,000
Contingencies Reserve Invested in 7% State Loan	12,00,000	Intangible assets	8,00,000
Loan from State Electricity Board	25,00,000	Tariffs and Dividends Control Reserve	10,00,000

12% Debentures	20,00,000	Current Assets	
Development Reserve	8,00,000	(monthly average)	15,00,000
Fixed Assets	2,50,00,000		
Depreciation Reserve on			
Fixed assets	30,00,000		

The company earned a profit of Rs. 28,00,000 (after tax) in 2007. Show how the profits have to be dealt with by the company, assuming that the Bank Rate was 10%.

All workings should form part of your answer.

Solution

Electricity Company

Statement of Distribution of Profits

Capital Base:	*Rs.*	*Rs.*
Fixed assets as reduced by Customers' contribution	2,48,00,000	
Intangible assets	8,00,000	
Current Assets (Monthly Average)	15,00,000	
Investment against Contingency Reserve	12,00,000	
		2,83,00,000
Deduct :		
Depreciation Reserve	30,00,000	
Loan from Electricity Board	25,00,000	
12% Debentures	20,00,000	
Development Reserve	8,00,000	
Consumers' Deposits	40,00,000	
Tariffs and Dividends Control Reserve	10,00,000	1,33,00,000
Capital		1,50,00,000
Reasonable return : Bank rate plus 2%		
12% on capital base Rs. 1,50,00,000		18,00,000
8% on Reserve Fund Investments		4,80,000
½% on loan from Electricity Board Debentures		
and Development Reserve (Rs. 53,00,000)		26,500
		23,06,500

Surplus and its disposal

Clear Profit	28,00,000

Surplus 28,00,000 — 23,06,500	4,93,500
Less: 20% of Reasonable Return	4,61,300
Amount refundable to consumers	32,200

Disposal of Surplus

(i)	1/3 of Surplus over clear profit limited to 5% of Reasonable return at the disposal of the company	1,15,325
(ii)	Credit to Tariffs and Dividend Control Reserve (½of balance)	1,72,988
(iii)	Credit of Consumer Suspense	1,72,987
		4,61,300

		Rs.
Total amount at the disposal of the company		
(a)	Amount of Reasonable Return	23,06,500
(b)	Share in surplus	1,15,325
		24,21,825

Illustration 4

The following balances relate to an electricity company and pertain to its accounts for the year ended 31st December, 2007 :

	Rs.
Share Capital	1,00,00,000
Reserve Fund (invested in 5% Government securities at par)	60,00,000
Contingencies Reserve-invested in 6% State Government loans	20,00,000
Loan from State Electricity Board	30,00,000
11% Debentures	8,00,000
Development Reserve	10,00,000
Fixed Assets	2,00,00,000
Depreciation Reserve on fixed assets	80,00,000
Consumers' deposits	75,00,000
Amount contributed by consumers towards fixed assets	2,00,000
Intangible assets	5,00,000
Tariffs and Dividend Control Reserve	6,00,000
Current assets-monthly average	20,00,000

The company earned a post tax profit of Rs. 9 lakhs. Show how the profits of the company will be dealt with under the provisions of the Electricity Act, assuming that the Bank rate during the year was 8%.

Solution

Capital Base :			*Rs.*
(a)	Original cost of Fixed Assets less amount contributed by customers		1,98,00,000
(b)	Cost of Intangible Assets		5,00,000
(c)	Original cost of work in progress		—
(d)	Investment against Contingencies Reserve		20,00,000
(e)	Monthly average of Current Assets (assumed not to cover book debts and amounts due to suppliers)		20,00,000
			2,43,00,000
Less :		*Rs.*	
(i)	Amount written off on account of depreciation	80,00,000	
(ii)	Loan from State Electricity Board	30,00,000	
(iii)	11% Debentures	8,00,000	
(iv)	Security Deposit of Customers	75,00,000	
(v)	Balance of Tariff and Dividends Control Reserve	6,00,000	
(vi)	Balance of Development Reserve	10,00,000	
			2,09,00,000
			34,00,000

Reasonable Return		*Rs.*
(i)	Yield at Standard Rate i.e., 8% + 2% on Capital Base	3,40,000
(ii)	Income from Reserve Fund Investments 5% on Rs. 60,00,000	3,00,000
(iii)	1/2% on Loan from Electricity Board	15,000
(iv)	1/2% Debentures	4,000
(v)	1/2% Balance of Development Reserve	5,000
		6,64,000

Disposal of Surplus	
Post tax profit	9,00,000
Reasonable Return	6,64,000

Surplus	2,36,000
Excess upto 20% of Reasonable Return	1,32,800
Amount refundable to consumers-credit to Consumers Benefit Account	1,03,200
Allocation of Surplus upto 20%	
Excess one-third limited to 5% of Reasonable Return at the disposal of the company	33,200
Half of balance to Tariff & Dividend Control Reserve	49,800
Balance to Consumers Benefit Account in addition to Rs. 1,03,200 shown above	49,800
	1,32,800
Amount due to be refunded to Consumers (1,03,200 + 49,800)	1,53,000
Amount to be transferred to Tariff and Dividend Control Reserve	49,800
Amount at the disposal of the company (6,64,000 + 33,200)	6,97,200
	9,00,000

3.5 CONTINGENCIES RESERVE

A sum equal to not less than 1/4% and not more than 1/2% of the original cost of fixed assets must be transferred from the revenue account to the Contingencies Reserve until it equals 5% of the original cost of fixed assets. The amount of the reserve must be kept in trust securities. The reserve can be utilised with the approval of the State Government for the following purposes:

(a) to meet expenses or loss of profits arising out of accidents, strikes or circumstances beyond the control of the management;

(b) to meet expenses on replacement or removal of plant or other works, expenses necessary for normal maintenance or removal; and

(c) to pay compensation, payable under law for which no other provision had been made.

Any loss or profit on sale of fixed asset has to be transferred to the Contingencies Reserve.

3.6 DEVELOPMENT RESERVE

An amount equal to income-tax and super tax (calculated at current rates) which would have been paid but for the development rebate allowed by income-tax authorities, has to be transferred to the Development Reserve Account.

If, in an accounting year, the clear profit excluding the special appropriation together with their accumulation, if any, in the Tariffs and Dividend Control Reserve less the amount to be credited to Development Reserve falls short of the reasonable return, the sum to be appropriated to the Development Reserve in respect of such accounting year may be reduced by the amount of the short fall: appropriations to the Development Reserve may be made over a period of five years. Development Reserve can be invested only in the business of the undertaking. On a transfer of the undertaking, the reserve should also be transferred to the purchaser.

3.7 RESTRICTIONS ON DIVIDENDS

Except with the previous consent of the State Government, no sums can be paid on share capital and no other distribution of profit shall be made to the shareholders in respect of any year of account so long as any of the following sums remain to be written off in the books of the undertaking namely :

(i) normal depreciation due for that year of account calculated in accordance with the provisions of paragraph VI;

(ii) equated instalment in respect of arrears of depreciation computed in accordance with the provisions of paragraph XI, for that year of account;

(iii) arrears, if any, in respect of normal depreciation referred to in clause (I) accumulated after the date of application of the provision of the Sixth Schedule to the licensee;

(iv) arrears, if any, in respect of equated instalment referred to in clause (*ii*).

Illustration 5

The trial balance of Noida Electric Supply Ltd. for the year ended 31st March, 2008 is as below:

(Rs. '000)

Particulars	*Dr.*	*Cr.*
Share Capital :		
Equity Shares of Rs. 10 each		250,00
14% Preference Shares of Rs. 100 each		75,00
Patents and trade mark	12,52	
15% Debentures		123,50
16% Term Loan		76,50
Land (additions during the year 10,25)	62,25	
Building (additions during the year 25,40)	175,67	
Plant & Machinery	285,29	
Mains	22,62	

Meters	15,75	
Electrical Instrument	7,65	
Office furniture	12,25	
Capital reserve		25,10
Contingency reserves		60,15
Transformers	82,20	
Net revenue account		26,75
Stock in hand	60,25	
Sundry debtors	31,23	
Contingency reserve investment	60,05	
Cash & Bank	16,27	
Public lamps	15,20	
Depreciation fund		129,08
Sundry Creditors		32,62
Proposed dividend		60,50
	859,20	859,20

During 2007-08, Rs. ('000) 50,00 of 14% preference shares were redeemed at a premium of 10% out of proceeds of fresh issue of equity shares of necessary amounts at a premium of 10%.

Prepare for the above period as per the prescribed format :

(i) Statement of share and loan capital.

(ii) Statement of Capital expenditure.

(iii) General Balance Sheet as on 31st March, 2008.

Solution

Statement I

Statement of Share and Loan Capital for the year ended 31st March, 2008

(Rs. '000)

Description of Capital	*Balance at the beginning of the year*	*Receipts during the year*	*Redeemed during the year*	*Balance at the end of the year*
A. Share Capital :				
Authorised Capital	—	—	—	—

	Issued and paid up capital				
	25,00,000 equity shares				
	of Rs. 10 each	200,00	50,00	—	250,00
	7,50,00 14% Preference				
	Shares of Rs. 100 each	125,00	—	50,00	75,00
		325,00	50,00	50,00	325,00
B.	Capital Reserve	25,10	—	—	25,10
C.	Loan Capital :				
	15% Debentures	123,50	—	—	123,50
	16% Term Loan	76,50	—	—	76,50
		200,00			200,00
D.	Other capital	—	—	—	—
	Total Capital raised and appropriated				
	(A + B + C + D)	550,10	50,00	50,00	550,10

Statement II

Statement of Capital Expenditure

for the year ended 31st March, 2008

(Rs. '000)

	Particulars	*Balance at the beginning of the year*	*Additions during the year*	*Retire-ments dur-ing the year*	*Balance at the end of the year*
A.	Intangible Assets :				
	Patents and trade marks	12,52	—	—	12,52
B.	Hydraulic Power Plant	—	—	—	—
C.	Steam Power Plant :				
	Land	52,00	10,25	—	62,25
	Building	150,27	25,40	—	175,67
	Plant & Machinery	285,29	—	—	285,29
		487,56	35,65	—	523,21

D.	Internal Combustion Power Plant	—	—	—	—
E.	Transmission Plant: Transformers	82,20	—	—	82,20
F.	Distribution Plant (H.V.)				
	Mains	22,62	—	—	22,62
	Meters	15,75	—	—	15,75
		38,37			38,37
G.	Distribution Plant (L.V.)		—	—	
H.	Public Lighting :				
	Public Lamps	15,20	—	—	15,20
I.	General Equipments :				
	Electrical Instruments	7,65	—	—	7,65
	Office Furniture	12,25	—	—	12,25
		19,90			19,90
	Total Capital Assets in use	655,75	35,65		691,40

Statement XI

General Balance Sheet as on 31st March, 2008

(Rs '000)

Correspon-ding figure of previous year	*Particulars*	*Amount*	*Correspon-ding figure of previous year*	*Particulars*	*Amount*
	Capital raised & appropriated			Capital Amount extended on works in use—	691,40
	Statement-I	550,10		Statement II	
	Contingency Reserve	60,15		Less: Depreciation fund	129,08
	Balance of net Return A/c	26,75			562,32
	Current Liabilities & Provisions :			Current Assets :	
	Sundry creditors	32,62		Stock in hand	60,25
	Proposed dividend	60,50		Sundry debtors	31,23
				Contingency Reserve	

		Investment	60,05
		Cash & Bank balances	16,27
	730,12		730,12

Illustration 6

Vidyut Electric Supply Co. Ltd., gives you the following extract from its trial balance as on 31st March, 2008 :

		Dr. *Rs.*	*Cr.* *Rs.*
Purchase of energy		62,25,000	
Salaries and wages (includes wages to sub-station labour of Rs. 3,40,00 and distribution labour Rs. 2,50,000)		12,00,000	
Repair & Maintenance :	*Rs.*		
Buildings	22,500		
Plant & Machinery	7,500		
Transformers	90,000		
Mains and services	5,10,000		
Lorries	18,000	6,48,000	
Establishment expenses		19,95,000	
Rent, rates and taxes		76,500	
Conveyance and travelling		60,000	
Audit fees		22,500	
General expenses		1,50,000	
Directors' fees and allowances		25,500	
Interest on loans		3,52,500	
Interest on consumers' security deposits		1,20,000	
Electricity duty		10,50,000	
Sale of energy :	*Rs.*		
Domestic	25,75,000		
Industrial	1,49,00,000		
			1,74,75,000

Rental of meters	1,05,000
Maintenance of public lamps	22,500
Hire on machines & goods	37,500
Misc. receipts	15,000
Net Revenue A/c (balance as on 1-4-2007	75,350

The following adjustments have to be made :

(a)	Depreciation for the year (includes depreciation on building, plant etc. of Rs. 9,25,000)	Rs.	17,25,000
(b)	Provisions for taxation	Rs.	22,80,000
(c)	Transfer to Contingency reserve	Rs.	2,25,000
(d)	Transfer to Development reserve	Rs.	1,20,000

The amount of reasonable return may be presumed to be Rs. 11,94,000.

You are required to prepare for the above period :

(i) Statement of operating revenues.

(ii) Statement of operating expenses.

(iii) Statement of Net revenue and appropriations account.

Solution

Statement III

Statement of Operating Revenues

For the year ended 31st March, 2008

Particulars of Revenue	*Corresponding amount for the previous year* *Rs.*	*Amount for the current year* *Rs.*
A. Net revenue by sale of electricity :		
Domestic		25,75,000
Industrial		1,49,00,000
Public lighting		22,500
Total revenue by sale of electricity		1,74,97,500

B.	Miscellaneous revenue from consumers :		
	Meter Rent		1,05,000
C.	Other revenues :		
	Hire on machinery & goods	37,500*	
	Misc. receipts	15,000	
	Total other revenues		52,500
	Total operating revenues (A + B + C)		1,76,55,000
	Less: Total operating expenses as per Schedule IV		1,32,97,500
	Net surplus carried to Net Revenue Account — Statement X		43,57,500

* Misc. receipts are considered to be operating in nature.

Statement IV

Statement of Operating Expenses

For the year ended 31st March, 2008

Particulars of Revenue		*Corresponding amount for the previous year Rs.*	*Amount for the year Rs.*
A.	Hydraulic Power Generation		—
B.	Steam Power Generation		—
C.	Internal Combustion Power Generation		—
D.	Power purchased		62,25,000
Total production expenses			62,25,000
E.	Transmission :		
(a)	Operation and maintenance :		
	Wages of substation labour		
	Repairs and maintenance :		3,40,000
	Buildings		22,500
	Plant & Machinery		7,500
	Transformers		90,000
			4,60,000

(b)	Depreciation :	
	Building, Plant and Transformer	9,25,000
Total	Transmission expenses	13,85,000
F.	Distribution (HV)	
(a)	Operation and maintenance :	
	Electricity duty	10,50,000
	Wages for distribution labour	2,50,000
	Repairs and Maintenance	—
	Mains and services	5,10,000
	Lorries	18,000
		18,28,000
(b)	Depreciation	8,00,000
	Total Distribution Expenses	26,28,000
G.	Distribution (LV)	—
H.	Public Lighting	—
I.	Consumers' Servicing	—
K.	General Establishment Charges :	
	Office salaries	6,10,000
	Rent and taxes	76,500
	Conveyance and travelling	60,000
	Establishment expenses	19,95,000
	Audit fees	22,500
	General expenses	1,50,000
	Total general establishment charges	29,14,000
L.	Other charges :	
	Interest on consumers' security deposits	1,20,000
		1,20,000
	M. Management Expenses :	
	Directors' fees and allowances	25,500
	Total operating expenses transferred to Statement III	1,32,97,500

Statement X

Statement of Net Revenue and Appropriation Account
For the year ended 31st March, 2008

Corres-ponding figure of previous year	*Particulars*	*Amount*	*Corres-ponding figure of previous year*	*Particulars*	*Amount*
		Rs.			*Rs.*
	To Provision for taxation	22,80,000		By Balance of Profit b/f	75,350
	To Contribution towards contingency reserve	2,25,000		Net operating surplus as per Statement III.	43,57,500
	To Contribution towards Development reserve	1,20,000			
	To Appropriation to Tariff and Dividends Control Reserve	63,150			
	To Appropriation to Consumers' Rebate Reserve	63,150			
	To Interest on Loan	3,52,500			
	To Balance of Profit carried over	13,29,050			
		44,32,850			44,32,850

Workings:

(a) Calculation of clear profit:

	Rs.	*Rs.*
Net operating surplus as per Statement III		43,57,500
Less: Interest on loans	3,52,500	
Less: Provision for taxation	22,80,000	
Less: Contribution towards contingency reserve	2,25,000	
Less: Contribution towards Development reserve	1,20,000	29,77,500
Clear profit		13,80,000

(b) Distribution of Surplus :

Surplus = Clear profit—Reasonable return		
= Rs. 13,80,000 — Rs. 11,94,000		1,86,000
1/3rd of surplus	62,000	
5% of Reasonable return	59,700	59,700
Whichever is less, is at the disposal of the undertaking		1,26,300
1/2 of above to Tariff and Dividend control reserve		63,150
Balance available for benefit of consumers		63,150
		1,26,300

Illustration 7

From the balances extracted from the books of the City Electric Supply Company Limited for the year ended 31st March, 2008, prepare annual accounts as per the format given in the Indian Electricity Rules, 1956.

The Authorised Capital of the company was Rs. 2,00,00,000 divided into shares of Rs. 100 each. Of this Rs. 20,00,000 was issued for cash and fully paid up. A bonus issue of Rs. 20,00,000 had also been made. The books showed the following balances as at 31st March, 2008 :

		Rs.
Share Capital		40,00,000
Mortgage Debentures		1,28,00,000
Buildings (additions during the year Rs. 5,00,000)		40,00,000
Mains (additions during the year Rs. 3,40,000)		10,00,000
Machinery, plant etc.	(-Do- 9,50,000)	50,00,000
Accumulators	(-Do- 10,400)	40,920
Land	(-Do- 5,80,000)	56,00,000
Public Lamps	(-Do- 26,000)	2,40,000
Tools and Loose Plant	(-Do- 7,000)	87,760
Rents		1,00,000
Rates and Taxes		76,720
Coal; Carriages etc.		5,36,160
Office Furniture and Fittings		9,800
Prepaid Expenses		16,000
Contingencies Reserve Investments		2,00,000

Sundry Debtors	14,60,000
Sundry Creditors	2,75,010
Capital Reserve	1,60,000
Stores in hand	12,64,000
Balance of Net Revenue Account	16,080
Auditors' Fees	20,000
Cash discount received on purchases	2,800
Meter and other Rents	68,200
Director's Remuneration	40,000
Office Salaries	89,200
General Office Expenses	60,000
I.F.C.I. loan secured on immovable properties	8,00,000
Repairs and Maintenance :	
Buildings	11,100
Plant	20,100
Distributing Equipment	43,680
Salaries to Engineers and officers :	
Generation	35,680
Distribution	10,200
Interest on Cont. Reserve Investments	6,000
Share Transfer Fees	200
Expenditure on public lamps :	
Attendance & Repairs	65,000
Renewals	22,000
Issurance Premia	19,200
Interest on Debentures and Loans	5,22,000
Electric Instruments	22,000
Receipts from Sale of Current :	
Lighting	12,60,000
Power	10,18,000
Public Lamps	2,50,000

Law Charges	6,000
Sales proceeds of Scrap	400
Depreciation Fund	3,20,000
Contingencies Reserve	2,00,000
Oil, Waste and Other Stores (consumed)	72,520
Wages : Generation	1,33,880
Distribution	92,680
Cash in hand	79,520
Cash at bank in Current Account	1,80,570

Appropriate Rs. 3,60,000 to Depreciation Fund and Rs. 80,000 to Contingencies Reserve and provide for dividend on ordinary shares at 4%.

Solution

Statement I

Statement of Share and Loan Capital for the year ended 31st March, 2008

Description of Capital	*Balance at the beginning of the year*	*Receipts during the year*	*Redeemed during the year*	*Balance at the end of the year*
	Rs.	*Rs.*	*Rs.*	*Rs.*
A. Share Capital :				
Authorised Capital				
2,00,000 equity shares				
of Rs. 100 each	2,00,00,000			
Issued & paid up capital				
40,000 equity shares of				
Rs. 100 each	40,00,000	-	-	40,00,000
Total Paid up capital	40,00,000			40,00,000
B. Capital Reserve	1,60,000	-	-	1,60,000
C. Loan Capital				

Mortgage Debentures	1,28,00,000	-	-	1,28,00,000
IFCI Loan	8,00,000	-	-	8,00,000
Total Loan Capital	1,36,00,000			1,36,00,000
D. Other Capital	-	-	-	-
Total Capital raised and appropriated (A + B + C + D)	1,77,60,000	-	-	1,77,60,000

Statement II

Statement of Capital Expenditure

For the Year ended 31st March, 2008

Particulars	*Balance at the beginning of the year*	*Additions during the year*	*Retirements during the year*	*Balance at the end of the year*
	Rs.	*Rs.*	*Rs.*	*Rs.*
A. Intangible assets	-	-	-	-
B. Hydraulic Power Plant	-	-	-	-
C. Steam Power Plant	-	-	-	-
Land	50,20,000	5,80,000	-	56,00,000
Building	35,00,000	5,00,000	-	40,00,000
Machinery, Plant etc.	40,50,000	9,50,000	-	50,00,000
	1,25,70,000	20,30,000		1,46,00,000
D. Internal Combustion Power Plant	-	-	-	-
E. Transmission Plant	-	-	-	-
F. Distribution Plant (HV) :				
Mains	6,60,000	3,40,000		10,00,000
Accumulators	30,520	10,400		40,920
	6,90,520	3,50,400		10,40,920
G. Distribution Plant (L.V.)	-	-	-	-
H. Public Lighting				

Public Lamps	2,14,000	26,000	-	2,40,000
I.General Equipments				
Loose Tools & Plant	80,760	7,000	-	87,760
Electrical Instruments	22,000	-	-	22,000
Office Furniture & Fittings	9,800	-	-	9,800
	1,12,560	7,000		1,19,560
Total Capital Assets in use	1,35,87,080	24,13,400		1,60,00,480

Statement III

Statement of Operating Revenues

for the year ended 31st March, 2008

	Particulars of Revenue	*Corresponding amount for the previous year.* *Rs.*	*Amount for the current year* *Rs.*
A.	Net revenue by sale of electricity:		
	Domestic or Residential		12,60,000
	Industrial		10,18,000
	Public Lighting		2,50,000
	Total revenue by sale of electricity		25,28,000
B.	Miscellaneous revenue from consumers:		
	Meter and other rents		68,200
C.	Other revenues:		
	Sale proceeds of scrap		400
	Cash discount on purchases		2,800
	Total other revenues		3,200
	Total operating revenues (A + B + C)		25,99,400
	Less: Total operating expenses as per Schedule IV		18,14,120
	Net Surplus carried to Net Revenue Account — Statement X		7,85,280

Statement IV

Statement of Operating expenses

for the year ended 31st March, 2008

Particulars of expenses	Corresponding amount for the previous year Rs.	Amount for the Current year Rs.
A. Hydraulic Power Generation	-	
B. Steam Power Generation		
(a) Operation:		
Coal, carriage etc.		5,36,160
Oil, waste & other stores		72,520
Salaries of engineers & Officers		35,680
Wages		1,33,880
Total operations		7,78,240
(b) Maintenance:		
Repairs & Maintenance:		
Building		11,100
Plant		20,100
Total Maintenance		31,200
(c) Depreciation:		
Building, Plant etc.		3,60,000
Total generation expenses (a + b + c)		11,69,440
C. Internal Combustion Power Generation		—
D. Power Purchased		—
Total Production Expenses (A + B + C + D)		11,69,440
E. Transmission:		—
F. Distribution (HV)		
(a) Operation and maintenance:		
Salaries of engineers & other officers		10,200
Wages		92,680
Repairs & Maintenance		43,680
(b) Depreciation		—
		1,46,560

G.	Distribution (M&LV)	—
H.	Public Lighting:	
	(a) Operation & maintenance:	
	Attendance & Repairs	65,000
	Renewals	22,000
		87,000
I.	Consumers' Servicing	—
K.	General Establishment Charges:	
	Office salaries	89,200
	Rents	1,00,000
	Rates & Taxes	76,720
	General Office Expenses	60,000
	Auditors' fees	20,000
	Law charges	6,000
	Insurance	19,200
	Total general establishment charges	3,71,120
L.	Other charges	—
M.	Management expenses	
	Directors remuneration	40,000
	Total operating expenses transferred to Statement III	18,14,120

Statement X

Statement of Net Revenue and Appropriations Account

for the year ended 31st March, 2008

Correspond-ding figure of previous year Rs.	Particulars	Amount Rs.	Corres-ponding figure of previous year Rs.	Particulars	Amount Rs.
1	2	3	4	5	6
	To Contribution towards contingency reserve	80,000		By Balance of profit brought forward	16,080
	To Debenture interest	5,22,000		By Net operating surplus	

			as per Statement III	7,85,280
To Proposed dividend	1,60,000	By	Interest on investment	6,000
To Balance carried over	45,560	By	Other receipts :	
			Share transfer fees	200
	8,07,560			8,07,560

Statement XI

General Balance Sheet as on 31st March, 2008

Correspon-ding figure of previous year Rs.	*Particulars*	*Amount Rs.*	*Corres-ponding figure of previous year*	*Particulars*	*Amount Rs.*
	Capital raised & appropriated (Statement-I)	1,77,60,000		Capital amount expended on works in use :	
	Reserve and surplus :			(Statement - II)	1,60,00,480
	Contingency reserve	2,80,000		Less: Depreciation fund	6,80,000
	Balance of Net Revenue				1,53,20,480
	A/c - Statement X	45,560		Current Assets :	
	Current Liabilities &			Stock in hand	12,64,000
	Provisions :		Sundry Debtors		14,60,000
	Creditors	2,75,010		Contingency	
	Proposed dividend	1,60,000		Reserve Investment	2,00,000
				Bank balance	1,80,570
				Cash in hand	79,520
				Prepaid expenses	16,000
		1,85,20,570			1,85,20,570

3.8 ANNUAL ACCOUNTS TO SHAREHOLDERS

Section 75A Sub-section (1) of the Electricity (Supply) Act, 1948 specifies that a generating company shall, before the expiry of 31st December of each year, submit to the promoting Government(s), annual accounts in such form as given in the Indian Electricity Rules, 1956. Sub-section (2) of the same section provides that an electricity generating company shall, within 6 months from the date of closure of the year, forward to the promoting Government(s), a copy of the Balance Sheet and Profit & Loss Account and the Auditors' Report in relation to the accounts of the year. A question may arise as to whether an electricity generating or distribution company can prepare their annual accounts as per Schedule VI of the Companies Act, 1956. Section 211 of the Companies Act, 1956 specifically exempts a company engaged in the generation or supply of electricity from following Schedule VI for the purpose of preparation of annual accounts. But the important point to be noted here is that Section 211 of the Companies Act exempts but not prohibits and electricity company from following Schedule VI. Also Section 11 of the Indian Electricity Act, 1910 provides that when any licensee (*i.e.,* an electricity generating company or distribution company) is exempted by order of the State Government in writing from following the format given in the Indian Electricity Rules, 1956, the licensee may not file and render such account in the format given in the Indian Electricity Rules. Therefore, with the permission of the concerned State Government, the electricity company may follow Schedule VI of the Companies Act for the purpose of preparation of annual accounts.

From the above discussion, it becomes clear that an electricity generating or distribution company should render certain financial information in the prescribed format to the State Government but at the same time such a company may, with the permission of the State Government, prepare its annual accounts for the shareholders by following Schedule VI of the Companies Act, 1956. In fact, this approach is followed by most of the electricity generating companies existing in India (For example CESC Ltd., The Amalgamated Electricity Co. Ltd. etc.). We give below an illustration to show how the annual accounts are prepared by an electricity generating company operating in India for presentation to its shareholders.

Self-Examination Questions

I. Objective Type Questions

Choose the most appropriate answer from the given options

1. Under double accounts system, profit or loss is derived from
   (a) Profit and loss account.
   (b) Revenue account.
   (c) Income and expenditure account.
   (d) Receipts and payments account.
2. Cost of licence is shown in the
   (a) Capital account.
   (b) Revenue account.
   (c) Income and expenditure account.
   (d) General balance sheet.

3. Preliminary expenses account appears on

   (a) Assets side of the general balance sheet.

   (b) Debit side of the revenue account.

   (c) Debit side of the Income and expenditure account.

   (d) Debit side Receipts and expenditure on capital account.

4. For the purpose of Final Accounts of Electricity Supply Companies, 'Reasonable Return' does not include

   (a) An amount equal to ½ per cent on loans advanced by the Electricity Board.

   (b) An amount equal to ½ per cent on the amount raised by the issue of debentures.

   (c) An amount equal to ½ per cent of the cost of intangible assets.

   (d) An amount equal to 12 per cent on loans advanced by the Electricity Board.

   [**Ans. 1.** (b); **2.** (a); **3.** (d); **4.** (c)]

II. Short Answer Type Questions

5. Write short notes on:

   (i) Contingency reserve.

   (ii) Capital base.

   (iii) Development reserve.

   (iv) Restriction on dividends.

   (v) Tarriffs and dividend control reserve.

III. Long Answer Type Questions

6. Explain provisions of reasonable return and disposal of surplus of electricity companies.

7. Describe the salient features of preparing final accounts and appropriation of profits in case of electricity companies.

IV. Practical Problems

8. The Moon Electricity Company had to discard a machine on 1st October, 2005. On 1st April, the depreciation provision in this respect stood at Rs. 1,50,000 against the cost of Rs. 2,50,000 as on 1st April, 1997. Show the affected accounts for 2005, assuming the machine realised Rs. 30,000 immediately on being discarded and in the normal course it would have been depreciated fully by 31st March, 2006.

9. The D Electricity Ltd. has to replace 1/4 of a main at a cost of Rs. 1,80,000 and lay an auxiliary main for the remaining length at a cost of Rs. 2,60,000. The original main had cost Rs. 2,40,000 twenty years ago when costs were one half of what they are now. Old materials realised Rs. 5,000. Give the journal entries that are required.

10. An electricity company earned a profit of Rs. 18,50,000 during 2007-08. The capital base was Rs. 1,50,00,000 after deducting the Electricity Board loan of Rs. 50,00,000. Beside the company had a reserve of Rs. 10,00,000 invested in 5% Government securities. How much profit would be at the disposal of the company ?

11. From the following details of Tata Power, you rae required to draw the capital account and general balance sheet as at 31st march, 2008 under the double accounts system:

    Authorised capital : 8,000 shares of Rs. 100 each.

    Issued capital: 4,000 shares of Rs. 100 each, fully paid up.

    13% debentures Rs.. 2,00,000; Trade creditors RS. 70,000; Reserve fund Rs. 80,000; Trade debtors Rs. 50,000 and cash at bank Rs. 40,000; Reserve fund investments (at cost) Rs. 1,00,000 with market value of Rs. 1,10,000; stock Rs. 30,000.

    Fixed assets as on 31.3.2007: Machinery RS. 3,00,000 Building RS. 2,00,000; Additions during the year: Machinery RS. 60,000; Building Rr. 50,000.

    Depreciation fund: Machinery Rs. 70,000; Building Rs. 50,000.

    Profit and loss account Rs. 40,000.

CHAPTER 8

DEPARTMENTAL ACCOUNTS

Learning Objectives

After studying this chapter, you will be able to:

- Allocate common expenditures of the organization among various departments on appropriate basis.
- Deal with the inter-departmental transfers and their accounting treatment.
- Calculate the amount of unrealized profit on unsold inter-departmental stock-in-hand at the end of the accounting year.
- Work on problems based on inter-departmental transfers at profit and calculation of unrealized profit on the remaining stock at the end of the accounting year.

1. INTRODUCTION

If a business consists of several independent activities, or is divided into several departments, for carrying on separate functions, its management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. This can be made possible only if departmental accounts are prepared. Departmental accounts are of great help and assistance to the managements as information for controlling the business more intelligently and effectively, since thereby all types of waste either of material or of money are readily detected; also attention is drawn to inadequacies or inefficiencies in the working of departments or units into which the business may be divided.

To prepare such accounts, it will be necessary first, for the income and expenditure of department to be separately recorded in subsidiary books and then for them to be accumulated under separate heads in a ledger or ledgers. This may be done by having columnar subsidiary books and a columnar ledger. Alternatively, a separate set of books may be kept for each department, including complete stock accounts of goods received from or transferred to other departments or as also sales. Even when separate sets of books are maintained for different departments, it will also be necessary to devise a basis for allocation of common expenses among the different departments.

2. BASIS OF ALLOCATION OF COMMON EXPENDITURE AMONG DIFFERENT DEPARTMENTS

(1) Expenses incurred specially for each department are charged directly thereto, *e.g.,* insurance charges of stock held by a department.

(2) Common expenses, the benefit of which is shared by all the departments and which are capable of precise allocation, (*e.g.,* rent, lighting expenses etc.) are distributed among the departments concerned on some equitable basis considered suitable in the circumstances of the case. Rent is charged to different departments according to the floor area occupied by each department, having regard to any favourable location specially allocated to a department. Lighting and heating expenses are distributed on the basis of consumption of energy by each department and so on.

(3) Common expenses which are not capable of accurate measurement are dealt with as follows:

   (i) Selling expenses, *e.g.,* discount, bad debts, selling commission, etc. are charged on the basis of sales.

   (ii) Administrative and other expenses, *e.g.,* salaries of managers, directors, common advertisement expenses, depreciation on assets, etc. are allocated equally among all the departments that have benefited thereby. *Alternatively,* no allocation may be made and such expenses may be charged to the combined Profit and Loss Account.

3. INTER-DEPARTMENTAL TRANSFERS

Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting thereby and credited to that providing it. The totals of such benefits should be disclosed in the departmental Profit and Loss Accounts, to distinguish them from other items of expenditure. Goods and services may be charged by one department to another usually on either of the following three bases: (*i*) Cost, (*ii*) Ruling market price, (*iii*) Cost *plus* agreed percentage of profit. When profit is added in the inter-departmental transfers the loading included in the unsold stock at the end of the year is to be excluded before final accounts are prepared so as to eliminate any anticipatory profit included therein. This is done by creating an appropriate stock reserve by debiting the combined Profit and Loss Account.

Illustration 1

Messrs D, B and R carried on a business of Drapers and Tailors in Delhi; D was incharge of Department "A" dealing in cloth, B of department "B" for selling garments and R of Department "C" the tailoring section. It had been agreed that each of the three partners would receive 75% of the profits disclosed by the accounts of the department of which he was in charge and the balance of the profits would be shared in the proportion: D 1/2, B 1/4, and R 1/4. The following is the Trading and Profit and Loss Account of the firm for the six months ended March 31, 2008.

Dr. **Trading and Profit and Loss Account** *Cr.*

		Rs.	*Rs.*			*Rs.*	*Rs.*
To	Opening Stock:			By	Sales :		
	Cloth (A)	37,890			Cloth (A)	1,80,000	
	Ready-made Garments (B)	24,000			Ready-made Garments (B)	1,30,000	
	Tailoring Jobs (C)	<u>20,000</u>	81,890		Tailoring Jobs (C)	<u>90,000</u>	4,00,000
To	Purchase :			By	Discount received		800
	Cloth (A)	1,40,700		By	Closing Stock:		
	Ready-made Garments (B)	80,600		By	Cloth (A)	45,100	
	Tailoring Goods (C)	<u>44,400</u>	2,65,700		Ready-made Garments (B)	22,300	
To	Salaries and Wages		48,000		Tailoring Jobs (C)	<u>21,600</u>	89,000
To	Advertising		2,400		[including Rs. 5,700 for goods		
To	Rent		10,800		transferred from		
To	Discount allowed		1,200		department (A)]		
To	Sundry Exp.		12,000				

To	Depreciation on			
	Furniture and Fittings	750		
	Net Profit	67,060		
		4,89,800		4,89,800

After consideration of the following, prepare Departmental Accounts and Profit and Loss Appropriation Account:

(i) Cloth of the value of Rs. 10,700 and other goods of the value of Rs. 600 were transferred at selling price by Departments A and B respectively to Department C.

(ii) Cloth and garments are sold in the show-room. Tailoring work is carried out in the workshop.

(iii) The details of salaries and wages were as follows:

(a) General Office 50%, show-room 25% and 25% for workshop, which is for tailoring.

(b) Allocate General Office Expenses, in the proportion of 3:2:1 among the Departments A, B, C.

(c) Distribute show-room expenses in the proportion of 1:2 between Departments A and B.

(iv) The workshop rent is Rs. 1,000 per month. The rent of the General Office and Show room is to be divided equally between Departments A and B.

(v) Depreciation charges are to be allocated equally amongst the three Departments.

(vi) All other expenses are to be allocated on the basis of turnover.

(vii) Discounts received are to be credited to the three Departments as follows: A: Rs. 400; B: Rs. 250; C: Rs. 150.

(viii) The opening stock of Department C does not include any goods transferred from Department A.

Solution

M/s D, B and R

Departmental Trading and Profit & Loss Account for the six months ended 31-3-2008

Dr.											*Cr.*
		A	*B*	*C*	*Total*			*A*	*B*	*C*	*Total*
To	Opening Stock	37,890	24,000	20,000	81,890	By	Sales	1,80,000	1,30,000	90,000	4,00,000
To	Purchases	1,40,700	80,600	44,400	2,65,700	By	Transfer	10,700	600	-	11,300
To	Transfer		-	11,300	11,300	By	Closing				
To	Wages		-	12,000	12,000		Stock	45,100	22,300	21,600	89,000
To	Gross profit c/d	57,210	48,300	23,900	1,29,410						
		2,35,800	1,52,900	1,11,600	5,00,300			2,35,800	1,52,900	1,11,600	5,00,300
To	Salaries & Wages:					By	Gross profit b/d	57,210	48,300	23,900	1,29,410
	General Office	12,000	8,000	4,000	24,000	By	Discount Received	400	250	150	800
	Showroom	4,000	8,000		12,000						
	Advertising	1,080	780	540	2,400						
To	Rent	2,400	2,400	6,000	10,800						
To	Discount Allowed	540	390	270	1,200						
To	Sundry Expenses	5,400	3,900	2,700	12,000						
To	Depreciation	250	250	250	750						
To	Net Profit c/d	31,940	24,830	10,290	67,060						
		57,610	48,550	24,050	1,30,210			57,610	48,550	24,050	1,30,210

Note: Gross profit of Department A is 30% in Sales (including transfer to Department C).

There is some unrealised profit only on inter departmental stock. 30% of Rs. 5,700 is as stock reserve. This will be debited to Profit and Loss Appropriation Account.

Profit & Loss Appropriation Account

		Rs.	*Rs.*			*Rs.*
To	Stock Reserve (See Note)		1,710	By	Net Profit, from Profit &	
To	D: 75% of Profit of				Loss A/c	67,060
	Deptt. A	23,955				
	50% of Common Pool	7,527	31,482			
To	B : 75% of Profit of					
	Deptt. B	18,623				
	25% of Common Pool	3,763	22,386			
To	R: 75% of Profit of					
	Deptt. C	7,718				
	25% of Common Pool	3,764	11,482			
			67,060			67,060

Illustration 2

Complex Ltd., has 3 departments, A, B, C. The following information is provided:

	A	B	C
	Rs.	Rs.	Rs.
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	
Wages	5,000	10,000	
Closing Stock	4,000	14,000	8,000
Sales			34,000

Stock of each department is valued at cost to the department concerned, Stocks of A department are transferred to B at a margin of 50% above departmental cost, Stocks, of B department are transferred to C department at a margin of 10% above departmental cost. Other expenses were:

	Rs.
Salaries	2,000
Printing & Stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profits on departmental stock were:

Department B Rs. 1,000

Department C Rs. 2,000

Prepare Departmental Trading and Profit & Loss Accounts for the year ending March 31, 2008.

Solution

Complex Ltd.

Departmental Trading and Profit & Loss Account for year ended 31-3-2008

Dr. *Cr.*

		A	B	C	Total			A	B	C	Total
		Rs.	Rs.	Rs.	Rs.			Rs.	Rs.	Rs.	Rs.
To	Opening Stock	3,000	4,000	6,000	13,000	By	Internal transfer	18,000	33,000	-	51,000
To	Direct material					By	Sales	-	-	34,000	34,000
	consumption	8,000	12,000	-	20,000	By	Closing stock	4,000	14,000	8,000	26,000
To	Wages	5,000	10,000	-	15,000						
To	Internal transfer	-	18,000	33,000	51,000						
To	Gross Profit c/d	6,000	3,000	3,000	12,000						
		22,000	47,000	42,000	1,11,000			22,000	47,000	42,000	1,11,000
To	Salaries	1,000	500	500	2,000	By	Gross				
To	Printing &						profit b/d	6,000	3,000	3,000	12,000
	Stationery	500	250	250	1,000	By	Net Loss c/d	2,000	1,000	1,000	4,000
To	Rent	3,000	1,500	1,500	6,000						
To	Depreciation	1,500	750	750	3,000						

To Interest paid	2,000	1,000	1,000	4,000					
	8,000	4,000	4,000	16,000		8,000	4,000	4,000	16,000
To Net Loss b/d				4,000	By Reserve for unrealised profit (on opening stock)				3,000
To Reserve for unrealised profit on closing stock				3,918	By Balance transferred to P & L A/c				4,918
				7,918					7,918

Working Notes:

Calculation of Unrealised Profit on Closing Stock:

Dept. B: Closing Stock Rs. 14,000

Cost element transferred from Deptt. A $\text{Rs.}14{,}000 \times \frac{18{,}000}{40{,}000}$ = Rs. 6,300

Profit added by Deptt. A $\text{Rs.}6{,}300 \times \frac{50}{150}$ = Rs. 2,100

Clarification: Cost increased during the current period by Deptt. B are Direct Material Rs. 12,000, Wages Rs. 10,000 and Transfer received from Deptt. A Rs. 18,000; Total Rs. 40,000.

So cost element of Deptt. A Rs. 18,000 in closing stock is $\frac{\text{Rs.}18{,}000}{\text{Rs.}40{,}000}$

(FIFO formula for stock issue is assumed)

Deptt. C: Closing Stock Rs. 8,000.

Profit added by Deptt. B: $\text{Rs.}8{,}000 \times \frac{10}{110}$ = Rs. 727

Cost element from Deptt. A:

$(\text{Rs.}8{,}000 - \text{Rs.}727) \times \frac{\text{Rs.}18{,}000}{\text{Rs.}40{,}000}$ = Rs. 3,273

Profit added by Deptt. A: $\text{Rs.}3{,}273 \times \frac{50}{150}$ = Rs. 1,091

Rs. 1,818

Total Unrealised Profit: Rs. 2,100 + Rs. 1,818 = Rs. 3,918

Illustration 3

Alpha Ltd., has a factory with two manufacturing departments 'X' and 'Y'. Part of the output of department X is transferred to department Y for further processing and the balance is directly transferred to selling department. The entire production of department Y is directly transferred to the selling department. Inter-departmental stock transfers are made as follows:

X department to Y department at 33-1/3% over departmental cost.

X department to selling department at 50% over departmental cost.

Y department to selling department at 25% over departmental cost.

The following information is given for the year ending 31st March, 2008.

	Department X		*Department Y*		*Selling Department*	
	Units	*Rs.*	*Units*	*Rs.*	*Units*	*Rs.*
Opening stock						
Finished Goods	60	60,000	20	40,000	50	1,28,000
Raw materials						
Raw material consumed		1,82,000		20,000		
Labour charges		70,000		32,000		
Sales					120	4,80,000
Closing stock						
Finished Goods	40		50		60	

Out of the total transfer by X department 30 units were transferred to selling department, while the remaining to department Y. Per unit material and labour consumption of X department on production to be transferred directly to the selling department is 300 per cent of the labour and material consumption on units transferred to Y department. General Administration expenses Rs. 1,80,000.

Prepare Departmental Profit and Loss Account and General Profit and Loss Account.

Solution

Working Notes:

(1) Calculation of production made by Department X

	Selling Deptt. *Units*	*Deptt. Y* *Units*	*Deptt. X* *Units*
Sales	120		
Transfer to Selling Deptt.		100	30
Transfer to X Deptt.			
Transfer to Y Deptt.			130
Closing Stock	60	50	40
	180	150	200
Opening Stock	50	20	60
Transfer from X Deptt.	30	130	
Transfer from Y Deptt. (balancing figure)	100		
Production during year (balancing figure)			140
	180	150	200

(2) Cost of Production and Transfer price

Department: X	*Units*	*Rs.*
Cost of output including opening stock		3,12,000
Transfer to selling department		
30 Units : Equivalent units	90	
Transfer to Y Department	130	
Closing Stock	40	
	260	

Cost of goods transferred to selling Department $\frac{3,12,000}{260} \times 90 = 1,08,000$

Transfer Price. Cost plus 50%: (Rs. 1,08,000 + 50% of Rs. 1,08,000) 1,62,000

Output meant for transfer to Department Y.

Cost of output: $\frac{3,12,000}{260} \times 130$ = Rs. 1,56,000

Transfer price: Cost plus 33.1/3%:

(Rs. 1,56,000 + 33.1/3% of Rs. 1,56,000)=		2,08,000
Total Transfer (Rs. 2,08,000 + Rs. 1,62,000)		3,70,000
Department Y		*Rs.*
Total cost of output		3,00,000
Total output	150 units	
Cost per unit		2,000
Cost of transfer to selling Deptt.	100 units	2,00,000
Transfer Price: Cost plus 25%		2,50,000

(3) Calculation of Closing Stock

			Rs.
Deptt. X $\frac{\text{Rs.}3,12,000}{260} \times 40$			48,000
Deptt. Y $\frac{\text{Rs.}3,00,000}{150} \times 50$			1,00,000
Selling Deptt (Closing Stock 60 units)	Units	Rs.	
Opening Stock	50	1,28,000	
Transfer from Deptt. X	30	1,62,000	
Transfer from Deptt. Y	100	2,50,000	
	180	5,40,000	
Average Cost		3,000	1,80,000

(4) Calculation of unrealised profit on stock

Deptt. Y: Increase in Stock (Rs. 1,00,000 — Rs. 40,000) = Rs. 60,000

Cost element of Deptt. X	Rs. 2,08,000
Cost of Deptt. Y	Rs. 52,000
Total Cost excluding Value of the Opening Stock:	Rs. 2,60,000

Proportion: $\frac{\text{Rs. }2,08,000}{\text{Rs. }2,60,000}$

Unrealised Profit: $\text{Rs. }60,000 \times \frac{2,08,000}{2,60,000} \times \frac{1}{4}$ = Rs. 12,000

Selling Deptt.:

Increase in Stock (Rs. 1,80,000 — Rs. 1,28,000) = Rs. 52,000

Total transfer from two departments = Rs. 4,12,000

Proportion of Deptt. X $\frac{\text{Rs. }1,62,000}{\text{Rs. }4,12,000}$

Proportion of Deptt. Y $\frac{2,50,000}{4,12,000}$

Output of Deptt. X in increase in Stock $\text{Rs. }52,000 \times \frac{1,62,000}{4,12,000}$ = Rs. 20,447

Output of Deptt. Y in increase in Stock $\text{Rs. }52,000 \times \frac{2,50,000}{4,12,000}$ = Rs. 31,553

Profit loaded by Deptt. Y $\text{Rs. }31,553 \times \frac{1}{5}$ =	Rs. 6,311
Profit loaded by Deptt. X	
For transfer from Deptt. Y $(\text{Rs. }31,553 - \text{Rs. }6,311) \times \frac{2,08,000}{2,60,000} \times \frac{1}{4}$ =	Rs. 5,048
For Direct Transfer $\text{Rs. }20,447 \times \frac{1}{3}$	Rs. 6,816
	Rs. 18,175

Departmental Profit and Loss Account for the year ended 31-3-2008

Dr.	X Deptt. Qty	X Deptt. Amount Rs.	Y Deptt. Qty	Y Deptt. Amount Rs.	Selling Deptt. Qty	Selling Deptt. Amount Rs.	Cr.	X Deptt. Qty	X Deptt. Amount Rs.	Y Deptt. Qty	Y Deptt. Amount Rs.	Selling Deptt Qty	Selling Deptt Amount Rs.
To Opening Stock	60	60,000	20	40,000	50	1,28,000	By Stock transf.	160	3,70,000	100	2,50,000		
To Raw Material							By Sales					120	4,80,000
consumption		1,82,000		20,000			By Closing						
Units produced	140						Stock	40	48,000	50	1,00,000	60	1,80,000
To Labour Charges		70,000		32,000									
To Stock Transferred from X Deptt.			130	2,08,000	30	1,62,000							
To Stock Transferred from Y Deptt.					100	2,50,000							
To Departmental Profit Transf. to General P & L A/c		1,06,000		50,000		1,20,000							
	200	4,18,000	150	3,50,000	180	6,60,000		200	4,18,000	150	3,50,000	180	6,60,000

General Profit and Loss A/c

	Rs.		Rs.
To General Expenses	1,80,000	By Profit transferred from	
" Stock Reserve for		X Deptt.	1,06,000
Closing Stock:		Y Deptt.	50,000
on Deptt. Y	12,000	Selling Deptt.	1,20,000
on Selling Deptt.	18,175		
" Net Profit	65,825		
	2,76,000		2,76,000

Illustration 4

Gram Udyog, a retail store, has two departments, 'Khadi and Silks' for each of which stock account and memorandum 'mark up' accounts are kept. All the goods supplied to each department are debited to the stock account at cost plus a 'mark up', which together make-up the selling-price of the goods and in the account of the sale proceeds of the goods are credited. The amount of 'mark-up' is credited to the Departmental Mark up Account. If the selling price of any goods is reduced below its normal selling price, the reduction 'marked down' is adjusted both in the Stock Account and the Departmental 'Mark up' Account. The rate of 'Mark up' for Khadi Department is 33-1/3% of the cost and for Silks Department it is 50% of the cost.

The following figures have been taken from the books for the year ended December 31, 2008:

	Khadi D	Silks D
	Rs.	Rs.
Stock as on January 1st at cost	10,500	18,600
Purchases	75,900	93,400
Sales	95,600	1,25,000

(1) The stock of Khadi on January 1, 2008 included goods the selling price of which had been marked down by Rs. 1,260. These goods were sold during the year at the reduced prices.

(2) Certain stock of the value of Rs. 6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for Rs. 10,350. As a result though cost of the goods is included in the Khadi Department the sale proceeds have been credited to the Silks Department.

(3) During the year 2008 to promote sales the goods were marked down as follows :

	Cost	*Marked down*
	Rs.	*Rs.*
Khadi	5,600	360
Silk	10,000	2,000

All the goods marked down, were sold except Silks of the value of Rs. 5,000 marked down by Rs. 1,000.

(4) At the time of stock-taking on December 31, 2008 it was discovered that Khadi cloth of the cost of Rs. 390 was missing and it was decided that the amount be written off.

You are required to prepare for both the departments for the year 2008.

(a) The Memorandum Stock Account; and

(b) The Memorandum Mark up Account.

Solution

Silk Stock Account

Dr.					*Cr.*
			Rs.		*Rs.*
2008				2008	
Jan. 1	To Balance b/d			Jan. By Sales A/c	1,25,000
	Cost	18,600		" Mark-up A/c	2,000
	Mark-up	9,300	27,900	" Balance c/d	51,350
"	Purchases	93,400			
	Mark-up	46,700	1,40,100		
"	Khadi A/c	6,900			
	Mark-up	3,450	10,350		
			1,78,350		1,78,350

Silk Mark-up Account

Dr.				*Cr.*
		Rs.		*Rs.*
2008			*2008*	
Jan. 1	To Stock A/c	2,000	Jan. 10 By Balance b/d	9,300
	" Profit & Loss A/c	41,000	" Stock A/c	46,700
	" Balance [(1/3 of 52,350) – 1,000]	16,450	" Stock A/c	3,450
		59,450		59,450

Working Notes:

Verification of Profit	*Rs.*
Sales	1,25,000
Add : Mark down in goods sold	1,000
	1,26,000

Gross Profit 1/3	42,000	
Less : Mark down	1,000	
Gross profit as per books	41,000	

Khadi Stock Account

2008			Rs.	Rs.	2008			Rs.	Rs.
Jan.	1	To Balance b/d				By	Sales		95,600
		(10,500 + 2,240)		12,740		"	Silk Deptt.	6,900	
	"	Purchases	75,900			"	Mark-up A/c	2,300	9,200
	"	Markup	25,300	1,01,200		"	Loss of stock A/c	390	
						"	Mark-up A/c	130	520
							Mark-up A/c		360
						"	Balance c/d		8,260
				1,13,940					1,13,940

Khadi Mark-up Account

2008			Rs.	2008			Rs.
	To	Stock A/c (transfer)	2,300	Jan. 1	By	Balance b/d	
	"	Stock A/c (re-sale)	130			(3,500 – 1,260)	2,240
	"	Stock A/c (mark down)	360		"	Stock A/c	25,300
	"	Profit & Loss A/c	22,685				
	"	Balance (1/4 of Rs. 8,260)	2,065				
			27,540				27,540

Working Note:

Verification of Profit	*Rs.*
Sales as per books	95,600
Add : Mark-down (1,260+360)	1,620
	97,220
Gross Profit on fixed selling price @ 25% on Rs. 97,220	24,305
Less : Mark down	1,620
	22,685

Illustration 5

Fairways Limited is a retail organisation with several departments. Goods supplied to each department are debited to a memorandum departmental stock account at cost, plus a fixed percentage (mark-up) to give the normal selling price. (The mark up is credited to a memorandum departmental 'Mark-up account"; any reduction in selling prices (mark-down) will require adjustment in the stock account and in mark-up account. The mark up for Department A for the last three years has been 40%.

Figures relevant to Department A for the year ended 30th June, 2006 were as follows:

Stock 1st July, 2007, at cost	80,000
Purchases, at cost	1,80,000
Sales	3,20,000

It is further ascertained that:

(1) Goods purchased in the period were marked down by Rs. 1,400 from a cost of Rs. 16,000. Marked-down stock costing Rs. 4,000 remained unsold on 30th June, 2008.

(2) Stock shortages at the year end, which had cost Rs. 1,200, were to be written off.

(3) Stock at 1st July, 2007 including goods costing Rs. 8,200 had been sold during the year and had been marked down in the selling price by Rs. 740. The remaining stock had been sold during the year.

(4) The departmental closing stock is to be valued at cost subject to adjustments for mark-up and mark-down.

You are required to prepare:

(i) A Departmental Trading Account for A Department for the year ended June, 2008 in Head Office books;

(ii) A Memorandum Stock Account for the year;

(iii) A Memorandum Mark-up Account for the year.

Solution

(i) **Trading Account (Department A)**

		Rs.			Rs.
To	Opening Stock	80,000	By	Sales	3,20,000
"	Purchases	1,80,000	"	Shortage	1,200
"	Gross Profit c/d	90,150	"	Closing stock	
				(Working Note 3)	28,950
		3,50,150			3,50,150

(ii) Memorandum Stock Account for the department

2007			Rs.	2007			Rs.
July 1	To Balance b/d				By Stock shortage A/c		
	Cost	80,000			P & L A/c	1,200	
	Mark-up	32,000			Mark-up A/c	480	1,680
		1,12,000			" Mark up A/c		1,400
	Less : Mark down	740	1,11,260		" Debtors A/c (Sales)		
	To Purchases :				Ex. Opening		
	Cost	1,80,000			Stock	1,11,260	
	Mark-up	72,000	2,52,000		Current		
					Purchase	2,08,740	3,20,000
				2008			
				June 30	By Balance c/d (W.N. 1)		40,180
			3,63,260				3,63,260

(iii) Memorandum Mark up Accounts

2007-08			Rs.	2007			Rs.
	To Memo. Stock A/c			July 1	By Balance b/d		
	re-shortage	480			(32,000 – 740)		31,260
	mark down	1,400	1,880		" Stock A/c		72,000
	" Gross Profit transferred to P&L A/c		90,150				
2008							
June 30	" Balance c/d		11,230				
			1,03,260				1,03,260

Working Notes :

(1) *Closing stock on FIFO basis*

		Rs.
Current purchases including mark-up		2,52,000
Sales Ex-current purchases	2,08,740	
Add : Mark-down in sales 3/4 of 1,400	1,050	2,09,790
		42,210

	Less : Mark-down 1/4 of 1,400	350
		41,860
	Less : Shortage	1,680
	Stock on 30th June, 2008	40,180
(2)	*Cost of Sales and Standard Gross Profit*	
	Sales as per books	3,20,000
	Add : Mark-down in opening stock	740
	Add : Mark-down Sales Ex-current purchases	1,050
	Value of sales if there was no mark-down	3,21,790
	Gross Profit 40/140 of Rs. 3,21,790	91,940
	Cost of sales	2,29,850
(3)	*Closing Stock*	
	Opening Stock	80,000
	Add: Purchases	1,80,000
		2,60,000
	Less: Cost of Sales	2,29,850
		30,150
	Less: Shortage	1,200
	Closing Stock	28,950
(4)	*Gross profit*	
	Standard Gross Profit on Sales	91,940
	Less: Mark-down (740+1,050)	1,790
		90,150
(5)	*Sales Ex-current purchases*	
	Total Sales	3,20,000
	Sales Ex-opening stock	1,11,260
		2,08,740

Illustration 6

X Ltd. has two departments, A and B. From the following particulars prepare the consolidated Trading Account and Departmental Trading Account for the year ending 31st December, 2008:

	A	B
	Rs.	Rs.
Opening Stock (at cost)	20,000	12,000
Purchases	92,000	68,000
Sales	1,40,000	1,12,000
Wages	12,000	8,000
Carriage	2,000	2,000
Closing Stock:		
(i) Purchased goods	4,500	6,000
(ii) Finished goods	24,000	14,000
Purchased goods transferred:		
by B to A	10,000	
by A to B		8,000
Finished goods transferred:		
by A to B	35,000	
by B to A		40,000
Return of finished goods:		
by A to B	10,000	
by B to A		7,000

You are informed that purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 20% of the finished stock (closing) at each department represented finished goods received from the other department.

Solution

X Ltd.

Departmental Trading A/c for the year ending 31st Dec., 2008

	Deptt. A.	Deptt. B		Deptt. A	Deptt. B
	Rs.	Rs.		Rs.	Rs.
To Stock	20,000	12,000	By Sales	1,40,000	1,12,000
" Purchases	92,000	68,000	" Pur. Goods Tr.	8,000	10,000
" Wages	12,000	8,000	" F.G. Transferred	35,000	40,000
" Carriage	2,000	2,000	Ret. finished Goods	10,000	7,000
" Purchased Goods			" Closing Stock:		
Transferred	10,000	8,000	Purchased Goods	4,500	6,000
" F.G. Transferred	40,000	35,000	Finished Goods	24,000	14,000
" Ret. of finished Goods	7,000	10,000			
	1,83,000	1,43,000			
" Gross profit c/d	38,500	46,000			
	2,21,500	1,89,000		2,21,500	1,89,000

Consolidated Trading Account for the year ending 31st December, 2008

	Rs.		Rs.
To Opening Stock	32,000	By Sales	2,52,000
" Purchases	1,60,000	" Closing Stock:	
" Wages	20,000	Purchased Goods	10,500
" Carriage	4,000	Finished Goods	38,000
" Stock Reserve	2,196		
" Gross Profit c/d	82,304		
	3,00,500		3,00,500

Working note:

	Deptt. A	Deptt. B
Closing Stock out of transfer	4,800	2,800

Sale	1,40,000	1,12,000
Add : Transfer	35,000	40,000
	1,75,000	1,52,000
Less: Returns	7,000	10,000
Net Sales plus Transfer	1,68,000	1,42,000
Rate of Gross profit	$\frac{38,500}{1,68,000}\times 100 = 22.916\%$	$\frac{46,000}{1,42,000}\times 100 = 32.394\%$
Unrealised Profit	4,800 × 32.394% = 1,555	2,800 × 22.916% = 641

Self-examination questions

I. Objective Type Questions

1. Selling commission is apportioned among departments in the proportion of
   (a) Average stock carried by each department
   (b) Number of units sold by each department
   (c) Sales of each department
   (d) None of the above

2. If goods are transferred from department A to department B at a price so as to include a profit of 50% on cost, the amount of stock reserve on closing stock of Rs. 9,000 in department B will be
   (a) Rs. 3,000
   (b) Rs. 4,500
   (c) Rs. 1,500
   (d) None of the above

   [**Answer 1.** (c), **2.** (a)]

II. Short Answer Type Questions

3. What are departmental accounts?

4. How would the following expenses be distributed among the various departments :
   (i) Managing director's salary and commission
   (ii) Advertisement charges
   (iii) Interest on borrowed capital

III. Long Answer Type Questions

5. Explain the basis of allocation of common expenditure among different departments.
6. Describe the term 'unrealised profit' and explain by the example the calculation of unrealised profit under different circumstances.

IV. Practical Questions

7. Becket & Co. purchased goods for its three departments as follows:

Department: X	4,000 Units
Department: Y	9,000 Units
Department: Z	4,000 Units

Total cost Rs. 1,10,000

Sales of three departments were as follows:

Department: X	3,600 Units @ Rs. 7.50 per unit
Department: Y	9,800 Units @ Rs. 9.00 per unit
Department: Z	3,650 Units @ Rs. 13.50 per unit

Opening Stock as on 1-1-2008 was as follows:

Department: X	200 Units
Department: Y	1,400 Units
Department: Z	150 Units

Assuming that the gross profit ratio is uniform in all the three departments, prepare trading a/c for the year ended 31st December, 2008.

8. Booming Limited has three departments. They are Alpha, Beta and Gamma. The profit of these departments are Rs. 30,000, Rs. 40,000 and Rs. 17,400 respectively. (Before charging manager's commission) and unrealised profit on stock transfers.

Department Alpha transfers its goods @ 20% profit on cost to other departments while Beta transfers its goods @ 10% profit on cost. However, department Gama transfers its goods at cost to other departments. However, respective Deptt.'s original goods are only transferred.

On scrutiny of records you find,

(i) Purchases made for Alpha Deptt. Rs. 10,000 has been debited in Beta Deptt. Account.

(ii) Goods sent on 'Sale or return basis' by Beta Deptt. @ 12% have been recorded as regular Sale at Rs. 8,400.

(iii) General expenses amounting to Rs. 2,100 have been excessively charged in Gama Deptt. instead of Beta Deptt.

(iv) The following transfers were made :

Deptt. Alpha	To Beta	Rs. 24,000	(Rs. 12,000 still in closing stock)
	To Gama	Rs. 3,600	
Deptt. Beta	To Gama	Rs. 11,000	(Rs. 4,400 still in closing stock)
Deptt. Gama	To Alpha	Rs. 7,700	(Rs. 3,000 still in closing stock)

(v) Commission payable to the Manager @ 10% on correct overall Company profit after charging such commission.

Find correct Net Profit of the Company and the commission payable to the General Manager.

9. Moon Ltd. has three departments. They are 'Cloth Stitching Deptt.', Selling Department and General Administration Department. Cloth Deptt. transfers its goods to Selling Deptt. @ 20% profit on Cost. From the following details, prepare Departmental Trading A/c and Profit and Loss A/c for the year ended 31st Dec., 2008.

	Cloth Stitching Deptt.	Selling Deptt.
	Rs.	Rs.
Opening Stock	1,20,000	80,000
Purchases	5,00,000	—
Wages and other exp.	1,25,000	25,000
Closing Stock	45,000	95,000
Sales	—	11,05,000

During the year goods costing Rs. 50,000 to selling department, were returned back to cloth department.

The expenses of General Admn. Deptt. are as follows :

Manager's Salary	@ Rs. 1,000 p.m.
Clerk's Salary (2 Nos.)	@ Rs. 600 p.m. (each)
Maintenance Expenses	Rs. 9,600

Apportion General Deptt. Expenses equally to the 'Cloth stitching' and 'Selling Deptt'.

CHAPTER 9

ACCOUNTING FOR BRANCHES INCLUDING FOREIGN BRANCHES

Learning Objectives

After studying this chapter, you will be able to:

- Distinguish between the accounting treatment of dependent branches and independent branches.
- Learn various methods of charging goods to branches.
- Solve the problems, when goods are sent to branch at wholesale price.
- Prepare the reconciliation statement of branch and head office transactions after finding the reasons for their disagreement.
- Incorporate branch balances in the head office book.
- Prepare branch accounts even on the basis of incomplete information.
- Differentiate between integral and non-integral foreign branches.
- Learn the techniques of foreign currency translation.

1. INTRODUCTION

The dictionary meaning of the word 'branch' is any subordinate division of a business, subsidiary shop, office, etc. According to the provisions contained in Section 29 of the Companies Act, 1956, it would appear that a branch is any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company. It must also be noted that the concept of a branch means existence of a head office for there can be no branch without a head office - the principal place of business. From the accounting point of view, branches may be classified as follows:

(i) Branches in respect of which the whole of the accounting records are kept at the head office,

(ii) Branches which maintain independent accounting records, and

(iii) Foreign Branches.

2. DEPENDENT BRANCHES

When the business policies and the administration of a branch are wholly controlled by the head office, its accounts also are maintained by it. Branch accounts, in such a case, are written up at the head office out of reports and returns received from the branch. Some of the significant types of branches that are operated in this manner are described below:

(a) A branch set up merely for booking orders that are executed by the head office. Such a branch only transmits orders to the head office;

(b) A branch established at a commercial centre for the sale of goods (wholesale) supplied by the head office, and under its direction all collections are made by the H.O.; and

(c) A branch for the retail sale of goods, supplied by the head office.

Accounting in the case of first two types is simple. Only a record of expenses incurred at the branch has to be maintained. But it is not so in the case of the third type. A retail branch is essentially a sales agency that principally sells goods supplied by the head office for cash and, if so authorised, also on credit to approved customers. Generally, cash collected is deposited into a local bank to the credit of the head office and the head office issues cheques thereon for meeting the expenses of the branch. In addition, the Branch Manager is provided with a 'float' for petty expenses which is replenished from time to time on an imprest basis. If, however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

There are various methods of recording transactions between the head office and a branch which vary from one another.

3. METHODS OF CHARGING GOODS TO BRANCHES

Goods may be invoiced to branches (1) at cost; or (2) at selling price; or (3) in case of retail branches, at wholesale price.

Note: The selling price method is adopted where the goods would be sold at a fixed price by the branch. It is suitable for dealers in tea, petrol, vanaspati ghee, etc. In this way, greater control can be exercised over the working of a branch in as much as that the branch balance in the head office books would always be composed of the value of unsold stock at the branch and remittances or goods in transit, any difference wherein being easily located. The arbitrary price method is usually adopted if the selling price is not known or when it is not considered desirable to disclose to the branch manager the profit made by the branch.

3.1 When goods are invoiced at cost: If goods are invoiced to the branch at cost, the trading results of branch can be ascertained by following either the Debtors Method or Stock and Debtors method. For the purpose, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is started in the head office books to which the price of goods or services provided or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

(a) Debtors method **:** The opening balance of stock, debtors (if any), petty cash (if any), are debited to the Branch Account; the cost of goods sent to branch as well as expenses of the branch paid by the head office, *e.g.,* salaries, rent, insurance, etc., are also debited to it. Conversely, amounts remitted by the branch and the cost of goods returned by the branch are credited. At the end of the year, the value of unsold stock, the total customers' balances outstanding and that of petty cash are brought into the branch account on the credit side and then, the branch account will reveal profit or loss; debit 'balance' will be the loss suffered by the working of the branch and *vice versa*. If the branch also is allowed to make small purchases of goods locally as well as to incur expenses as only details of such expenditure will be furnished by the branch to the head office. If on the other hand, purchases are made out of cash receipts, it will also be necessary for the branch to supply to the head office a copy of the Cash Account, showing details of cash collections and disbursements. To illustrate the various entries which are made in the Branch Account, the proforma of a Branch Account is shown below:

Proforma Branch Account

To Balance b/f	By Cash remitted
Stock	Return to H.O.
Debtors	By Balance c/d
Petty Cash	Cash
To Goods sent to Branches	Debtors
Bank	Petty Cash
Salaries	By Profit and Loss A/c—Loss
Rent	(if debit side is larger)
Sundry Expenses	
To Profit & Loss A/c—Profit	
(if credit side is larger)	

Note: Having credited the Branch Account by the actual cash received from debtors it would be wrong to debit the Branch Account, in respect of discount or allowances to debtors.

The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

Illustration 1

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office.

From the following, prepare Nagpur branch account in the books of head office by Debtors method:

Opening balance 1-1-2008	Rs.		Rs.
Imprest Cash	2,000	Bad Debts	1,000
Sundry Debtors	25,000	Discount to Customers	2,000
Stock: Transferred from H.O.	24,000	Remittances to H.O.	
Direct Purchases	16,000	(recd. by H.O.)	1,65,000
Cash Sales	45,000	remittances to H.O.	
Credit Sales	1,30,000	(not recd. by H.O. so far)	5,000
Direct Purchases	45,000	Branch Exp. directly paid by H.O.	30,000
Returns from Customers	3,000	Closing Balance (31-12-2008)	
Goods sent to branch from H.O.	60,000	Stock: Direct Purchase	10,000
Transfer from H.O. for Petty		Transfer from H.O.	15,000
Cash Exp.	4,000	Debtors	?
		Imprest Cash	?

Solution

In the Books of Buckingham Bros, Bombay

Nagpur Branch Account

Dr.						*Cr.*
			Rs.			*Rs.*
To	Opening Assets	Branch		By	Bank – Remittances	
	Stock		40,000		rec. from the branch	

	Debtors	25,000	Cash Sales	45,000	
	Imprest Cash	2,000	Cash from Drs.	1,20,000	
"	Goods sent to Branch A/c	60,000	Cash from Drs. in transit	5,000	1,70,000
	Creditors (Direct Pur.)	45,000			
	Bank (Sundry exp.)	30,000	Branch Assets at close		
	Bank (Petty Cash exp.)	4,000	Stock: Transfer from H.O.		15,000
	Net Profit transferred to		Direct Purchase		10,000
	General Profit & Loss A/c	15,000	Sundry Debtors (W.N. 2)		24,000
			Imprest Cash (W.N. 3)		2,000
		2,21,000			2,21,000

Working Notes:

(1) Collections from debtors:

	Rs.
Total remittances (Rs. 1,65,000 + Rs. 5,000)	1,70,000
Less: Cash sales	45,000
	1,25,000

(2) Calculation of Sundry Debtors closing Balance:

	Rs.
Opening Balance	25,000
Add: Credit Sales	1,30,000
	1,55,000
Less: Returns, Discount, Bad debts & collections (Rs. 3,000 + 2,000 + 1,000 + 1,25,000)	1,31,000
Closing balance	24,000

(3) It is assumed that petty cash expenses of the branch for the year were Rs. 4,000.

(b) Branch Trading and Profit and Loss Account Method: In this approach, Profit and Loss accounts are prepared considering each branch as a separate entity. The main advantage in this method is that, it is easy to prepare and understand.

Illustration 2

From the information given in the illustration 1, prepare Nagpur Branch Trading and Profit and Loss Account in the books of head office.

Solution

Buckingham Bros. Bombay

Nagpur Branch-Trading and Profit and Loss Account

For the year ending 31st December, 2008

		Rs.			Rs.	Rs.
To	Opening Stock	40,000	By	Sales		
"	Goods transferred from			Cash	45,000	
	Head Office	60,000		Credit sales	1,30,000	
"	Purchases	45,000			1,75,000	
"	Gross Profit c/d	52,000		*Less:* Returns	3,000	1,72,000
			"	Closing Stock		25,000
		1,97,000				1,97,000
To	Expenses	30,000	By	Gross Profit b/d		52,000
"	Discounts	2,000				
"	Bad Debts	1,000				
"	Petty Cash Expenses	4,000				
"	Net Profit transferred to					
	General P/L A/c	15,000				
		52,000				52,000

The students may note that Gross Profit and Net Profit earned by the branch are ascertainable in this method and also evaluating the performance of the branch is very much easier in this method than in the 'Debtors method'.

(c) Stock and Debtors method: If it is desired to exercise a more detailed control over the working of a branch, the accounts of the branch are maintained under what is described as the Stock and Debtors Method. According to this method, the under-mentioned four accounts have to be kept:

(*a*) Branch Stock Account (or Branch Trading Account).

(*b*) Branch Profit & Loss Account.

(*c*) Branch Debtors Account (if any).

(*d*) Branch Expenses Account.

If the branch is also allowed to purchase goods locally and to incur expenses out of its cash collections, it would be necessary to maintain (*i*) a Branch Cash Account, and (*ii*) an independent record of branch assets. All these accounts are kept by the H.O.

The manner in which entries are recorded in the above method is shown below:

	Transaction	Account debited	Account credited
(*a*)	Cost of goods sent to the Branch	Br. Stock A/c	Goods sent to Br. A/c
(*b*)	Remittances for expenses	Br. Cash A/c	(H.O.) Cash A/c
(*c*)	Any assets (*e.g.* furniture) provided by H.O.	Br. Asset (Furniture) A/c	(*i*) (H.O.) Cash A/c or (*ii*) Creditors A/c (*iii*) (H.O.) Furniture A/c
(*d*)	Cost of goods returned by the branch	Goods sent to Br. A/c	Br. Stock A/c
(*e*)	Cash Sales at the Branch	Br. Cash A/c	Br. Stock A/c
(*f*)	Credit Sales at the Branch	Br. Debtors A/c	Br. Stock A/c
(*g*)	Return of goods by debtors to the Branch	Br. Stock A/c	Br. Debtors A/c
(*h*)	Cash paid by debtors	Br. Cash A/c	Br. Debtors A/c
(*i*)	Discount & allowance to debtors, bad debts	Br. Expenses A/c	Br. Debtors A/c
(*j*)	Remittances to H.O.	(H.O.) Cash A/c	Br. Cash A/c
(*k*)	Expenses met by H.O.	Br. Expenses A/c	(H.O.) Cash A/c

(*l*) *Closing Stock*: Credit the Branch Stock Account with the value of closing stock at cost. It will be carried down as opening balance (debit) for the ensuing period. The Balance of the Branch Stock Account, (after adjustment therein the value of closing stock), if in credit, will represent the gross profit on sales and vice versa.

Other Steps

(*m*) Transfer Balance of Branch Stock Account to the Branch Profit and Loss Account.

(*n*) Transfer Balance of Branch Expenses Account to the debit of Branch Profit & Loss Account.

(o) The balance in the Branch P&L A/c will be transferred to the (H.O.) Profit & Loss Account.

The credit balance in the Goods sent to Branches Account is afterwards transferred to the Head Office Purchase Account or Trading Account (in case of manufacturing concerns), it being the value of goods transferred to the Branch.

Given below is a simple problem, the solution whereto has been prepared in all the three methods so as to show the distinguishing features of these methods.

Illustration 3

The Bombay Trading Company invoiced goods to its Delhi branch at cost. Head Office paid all the branch expenses from its bank account except petty cash expenses which were met by the Branch. All the cash collected by the branch was banked on the same day to the credit of the Head Office. The following is a summary of the transactions entered into at the branch during the year ended December 31, 2008.

	Rs.		*Rs.*
Stock January 1	7,000	Bad Debts	600
Debtors, January 1	12,600	Goods returned by customers	500
Petty Cash, January 1	200	Salaries & Wages	6,200
Goods sent from H.O.	26,000	Rent & Rates	1,200
Goods returned to H.O.	1,000	Sundry Expenses	800
Cash Sales	17,500	Cash received from Sundry	
Credit Sales	28,400	Debtors	28,500
Allowances to customers	200	Stock, Dec. 31	6,500
Discount to customers	1,400	Debtors, Dec. 31,	9,800
		Petty Cash, Dec. 31	100

Prepare: (*a*) Branch Account (Debtors Method), (*b*) Memorandum Branch Trading and Profit & Loss Account to prove the results as disclosed by the Branch Account and (*c*) Branch Stock Account, Branch Profit & Loss Account, Branch Debtors and Branch Expenses Account by adopting the Stock and Debtors Method.

Solution

Debtors Method

(A) Delhi Branch Account

Dr.									*Cr.*
2008			*Rs.*	*Rs.*	*2008*			*Rs.*	*Rs.*
Jan. 1	To	Balance b/d			Dec. 31	By	Bank		
		Stock	7,000				Cash Sales	17,500	
		Debtors	12,600				Cash from		
		Petty cash	200	19,800			Sundry Debts.	28,500	46,000
Dec. 31	To	Goods sent to				By	Goods sent to		
		Branch A/c		26,000			Br. A/c – Returns		
	To	Bank:					to H.O.		1,000
		Salaries & Wages	6,200			By	Balance c/d		
		Rent & Rates	1,200				Stock	6,500	
		Sundry Exp.	800	8,200			Debtors	9,800	
	To	Balance being					Petty Cash	100	16,400
		Profit carried to (H.O.) P & L A/c		9,400					
				63,400					63,400
Jan. 1, 2009	To	Balance b/d		16,400					

(B) Memorandum Branch Trading and Profit and Loss Account

Dr.								*Cr.*
Jan. 1		*Rs.*	*Rs.*				*Rs.*	*Rs.*
To	Stock		7,000	By	Sales:			
To	Goods sent				Cash		17,500	
	from H.O.	26,000			Credit	28,400		
	Less : Returns to H.O.	1,000	25,000		*Less:* Returns	500	27,900	45,400
To	Gross profit c/d		19,900	By	Closing Stock			6,500
			51,900					51,900
To	Salaries & Wages		6,200	By	Gross Profit b/d			19,900
To	Rent & Rates		1,200					
To	Sundry Exp.		800					
To	Petty Cash Exp.		100					
To	Allowances to Customers		200					
To	Discounts		1,400					
To	Bad Debts		600					
To	Net Profit		9,400					
			19,900					19,900

Stock and Debtors Method

Branch Stock Account

Dr.									*Cr.*
2008			*Rs.*	*2008*				*Rs.*	*Rs.*
Jan. 1	To	Stock	7,000	Dec. 31	By	Sales:			
Dec. 31	To	Goods Sent to Branch A/c	26,000			Cash		17,500	
						Credit	28,400		
	To	Branch P & L A/c (Gross profit c/d)	19,900			*Less:* Ret.	500	27,900	45,400

					By	Goods sent to Br. A/c - Return	1,000
					By	Balance c/d (Stock)	6,500
			52,900				52,900
2009 Jan. 1	To	Balance b/d	6,500				

Delhi Branch Debtors Account

Dr.							*Cr.*
2008			*Rs.*	*2008*			*Rs.*
Jan. 1	To	Balance b/d	12,600	Dec. 31	By	Cash	28,500
Dec. 31	To	Sales	28,400		By	Returns	500
					By	Allowances	200
					By	Discounts	1,400
					By	Bad Debts	600
					By	Balance c/d	9,800
			41,000				41,000
Jan 1	To	Balance b/d	9,800				

Delhi Branch Expenses Account

Dr.							*Cr.*
2008			*Rs.*	*2008*			*Rs.*
Dec. 31	To	Salaries & Wages	6,200	Dec. 31	By	Branch P & L A/c	10,500
	To	Rent & Rates	1,200				
	To	Sundry Expenses	800				
	To	Petty Cash Expenses	100				
	To	Allowances to customers	200				

	To	Discounts	1,400				
	To	Bad Debts	600				
			10,500				10,500

Delhi Branch Profit & Loss Account

2008			Rs.	2008			Rs.
Dec. 31	To	Branch Exp. A/c	10,500	Dec. 31	By	Gross Profit b/d	19,900
	To	Net Profit to					
		General P & L A/c	9,400				
			19,900				19,900

3.2 When goods are invoiced at selling price: The consideration on which this method is applied and types of business for which it is considered suitable have already been stated. It would be obvious that if Branch Account is debited with the sales price of goods and subsequent to the debit being raised there is a change in the sale price, the amount of debit either has to be increased or reduced on a consideration of the quantity of unsold stock that was there at the branch at the time the change took place. Such an adjustment will be necessary as often as the change in sale price occurs.

Moreover the amount of anticipatory profit, included in the value of unsold stock with the branch at the close of the year will have to be eliminated before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve. It may also be necessary to adjust the value of closing stock on account of the physical losses of stock due to either pilferage or wastages which may have occurred during the year. The last mentioned adjustments are made by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the lost goods), to the Branch Adjustment Account. The three different methods that are usually adopted for maintaining accounts on this basis are described below:

(*a*) *Stock and Debtors Method*: For the purpose, it would be necessary to maintain accounts mentioned below at the head office:

Branch Stock Account.

Goods sent to Branches Account.

Branch Adjustment Account.

Some important points should be kept in mind while following stock and debtors method:

(*i*) Entries in the accounts are made in the following manner:

	Transaction	Accounts debited	Accounts credited
(*a*)	Sale price of the goods sent from H.O. to the Branch	Branch Stock A/c (at selling price)	(*i*) Goods sent to Branches A/c with cost of the goods sent. (*ii*) Branch Adjustment A/c (with the loading *i.e.*, difference between the selling and cost price).
(*b*)	Return of goods By the Branch to H.O.	(*i*) Goods sent to Br. A/c (with the cost of goods returned). (*ii*) Branch Adjustment A/c (with the loading)	Branch Stock A/c
(*c*)	Cash sales at the Br.	Cash/Bank A/c	Branch Stock A/c
(*d*)	Credit Sales at the Br.	Branch Debtors A/c	Branch Stock A/c
(*e*)	Goods returned to Branch by customers	Branch Stock A/c	Branch Debtors A/c (at selling price)
(*f*)	Goods lost in Transit or stolen	(*i*) Goods Lost in Transit A/c or Goods Stolen A/c (with cost of the goods) (*ii*) Branch Adjustment A/c (with the loading)	Branch Stock A/c

(*ii*) *Closing Stock*: The balance in the Branch Stock Account at the close of the year normally should be equal to value of the unsold stock at the Branch valued at sale price. But quite often the value of stock actually held at the branch is either more or less than the balance of the Branch Stock Account. In that event it will be necessary that the balance in the

Branch Stock Account is increased or reduced by debit or credit to Goods Lost Account (at cost price of goods) and Branch Adjustment Account (with the loading). The Stock Account at selling price, thus reveals loss of stock (or surplus) and serves as a check on the branch in this respect.

The discrepancy in the amount of balance in the Branch Stock Account and the value of stock actually in hand, valued at sale price, may be the result of one or more of the under-mentioned factors :

An error in applying the percentage of loading.

Goods having been sold either below or above the established selling price.

A Commission to adjust returns or allowances.

Physical loss of stock due to natural causes or pilferage.

Errors in Stock-taking.

For example, the balance brought down in the Branch Stock Account is Rs.100 in excess of the value of stock actually held by the branch when the goods were invoiced by the head office to the branch at 20% above cost and the discrepancy is either due to pilferage or loss by fire, the actual loss to the firm would be Rs. 80, since 20% of the invoice price would represent the element of profit. The adjusting entry in such a case would be:

		Rs.	*Rs.*
Goods Lost A/c	Dr.	80	
Branch Adjustment A/c	Dr.	20	
To Branch Stock A/c			100

If on the other hand, a part of the sale proceeds has been misappropriated, then the adjusting entry would be:

Loss by theft A/c	Dr.
Branch Adjustment A/c	Dr.
To Branch Stock A/c	

Rebates and allowances allowed to customers are adjusted by debiting the amounts of such allowances to Branch Adjustment Account and crediting Branch Stock Account. But, if the gross amount of sale has been debited to Branch debtors Account, this account would be credited instead of Branch Stock Account, since the last mentioned account would have already received credit for the full value.

In the Goods Sent to Branch Account, the cost of the goods sent out to a branch for sale is credited by debiting Branch Stock Account. Conversely, the cost of goods returned by the branch is debited to this account. As such the balance in the account at the end of the year will be the cost of goods sent to the branch; therefore, it will be transferred either to the Trading Account or to Purchases Account of the head office.

To the Branch Adjustment Account the amount of profit anticipated on sale of goods sent to the branch is credited and conversely, the amount of profit not realised in respect of goods returned by the branch to head office or that in respect to stock remaining unsold with the branch at the close of the year is debited. The balance in this account, at the end of year thus will consist of the amount of Gross Profit earned on sale by the branch. On that account, it will be transferred to the Branch Profit and Loss Account.

(*iii*) *Elimination of unrealised profit in the closing stock*: The balance in the Branch Stock account would be at the sale price; therefore it would be necessary to eliminate the element of profit included in such closing stock. This is done by creating a reserve against unrealised profit, by debiting the Branch Adjustment Account and crediting Stock Reserve Account with an amount equal to the difference in the cost and selling price of unsold stock. Sometimes instead of opening a separate account in respect of the reserve, the amount of the difference is credited to Branch Stock Account. In that case, the credited balance of such a reserve is also carried forward separately, along with the debit balance in the Branch Stock Account; the difference between the two would be the value of stock at cost.

In either case, the credit balance will be deducted out of the value of closing stock for the purpose of disclosure in the balance sheet, so that the stock is shown at cost.

In either case, the credit balance will be deducted out of the value of closing stock for the purpose of disclosure in the balance sheet, so that the stock is shown at cost.

***An Alternative method*:** Where the gross profit of each branch is not required to be ascertained separately, although the selling price is uniform, the amount of goods sent to the branch is recorded only in two accounts namely - Branch Stock Account and Goods Sent to Branch A/c. At the end of the year the Branch Stock Account is closed by transfer of the balance representing the value of closing stock, at sale price, to the Goods Sent to Branch Account. This has the effect of altogether eliminating from the books the value of stock at the branch. The balance of Goods sent to Branch Account is afterwards transferred to the Trading Account representing the net sale price of goods sold at the branch. In that case, the value of closing stock at the branch at cost will be subsequently introduced in the Trading Account together with that of closing stock at the head office. Alternatively, a balance equal to the value of the closing stock in both the accounts would be carried forward.

Illustration 4

Harrison Ltd., Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording.

Following further details are given for the year ended 31st December, 2008.

	Rs.
Cost of goods sent to Branch at cost	2,00,000
Goods received by Branch till 31-12-2008 at invoice price	2,20,000
Credit Sales for the year @ invoice price	1,65,000
Cash Sales for the year @ invoice price	59,000
Cash Remitted to head office	2,22,500
Expenses paid by H.O.	12,000
Bad Debts written off	750

Balances as on	1-1-2008	31-12-2008
	Rs.	*Rs.*
Stock	25,000 (Cost)	28,000 (invoice price)
Debtors	32,750	26,000
Cash in Hand	5,000	2,500

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 2008.

Books of Harrison Ltd.

Branch Stock A/c

		Rs.			*Rs.*
1-1-08	To Balance b/d	30,000		By Branch Debtors	1,65,000
	To Goods Sent to Branch A/c	2,40,000		By Branch Bank	59,000
	To Branch Adjustment A/c (Excess of sale over invoice price)	2,000	31-12-08	By Balance c/d Goods in Transit (Rs. 2,40,000 – Rs. 2,20,000)	20,000

					Stock at Branch	28,000
		2,72,000				2,72,000

Bank Debtors A/c

		Rs.				Rs.
1-1-08	To Balance b/d	32,750		By	Bad Debts w/o	750
	To Branch Stock	1,65,000		By	Branch Cash-collection (balancing figure)	1,71,000
			31-12-08	By	Balance c/d	26,000
		1,97,750				1,97,750

Branch Cash A/c

		Rs.				Rs.
1-1-08	To Balance b/d	5,000		By	Bank Remit to H.O.	2,22,500
	To Branch Stock	59,000		By	Branch Adjustment A/c (exp. paid by H.O.)	12,000
	To Bank (as per contra)	12,000		By	Branch Adjustment A/c [Bal. fig. (exp. paid by Branch)]	10,000
	To Branch Debtors	1,71,000				
			31.12.08	By	Balance c/d	2,500
		2,47,000				2,47,000

Branch Adjustment A/c

	Rs.		Rs.
To Stock Reserve (on closing stock 48,000 × 1/6)	8,000	By Stock Reserve opening	5,000
		By Goods sent to Branch A/c	40,000
To Gross Profit c/d	39,000	By Branch Stock A/c	2,000
	47,000		47,000
To Branch Expenses (paid by HO : Rs. 12,000 and paid by Branch Rs. 10,000)	22,000	By Gross Profit b/d	39,000

To Branch Debtors-Bad debts	750		
To Net Profit	16,250		
	39,000		39,000

Goods Sent to Branch A/c

To Branch Adjustment A/c	40,000	By Branch to Stock A/c	2,40,000
To Purchase A/c - Transfer	2,00,000		
	2,40,000		2,40,000

(*b*) ***Debtors Method*****:** Under such a method, the principal accounts that will be maintained are:

The Branch Account;

The Goods Sent To Branch Account; and

The Stock Reserve Account.

Entries in these accounts will be made in the following manner:

	Transaction	Account debited	Account credited
(*a*)	Goods sent to Branch at selling price	Branch A/c	Goods Sent to Br. A/c
(*b*)	'Loading being the difference between selling price and cost of goods	Goods Sent to Br. A/c	Branch A/c
(*c*)	Returns to H.O. at selling price	Goods Sent to Br. A/c	Branch A/c
(*d*)	'Loading' in respect of goods returned to H.O.	Branch A/c	Goods Sent to Br. A/c
(*e*)	'Loading' included in the opening stock to reduce it	Stock Reserve A/c	Branch A/c
(*f*)	Closing stock at selling price	Branch Stock A/c	Branch A/c
(*g*)	'Loading' included in closing stock to reduce it to cost	Branch A/c	Stock Reserve A/c

It will be observed that entries in the Branch Account in respect of goods sent to a branch or returned by it, as well as those for the opening and closing stock, will be at selling price. In consequence, the Branch Account is written up at selling price. Hence the Branch Account will not correctly show the trading profit of the Branch unless these amounts are adjusted to cost. Such an adjustment is effected by making contra entries in 'Goods Sent to Branch A/c' and 'Stock Reserve Account'. In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to close; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch Account.

Illustration 5

Take figures from Illustration 4 and prepare branch account following debtors method.

Books of Harrison Ltd.

New Delhi Branch Account

Dr.						Cr.
1-1-2008						
To	Balance b/d	Rs.	By	Balance b/d		Rs.
	Stock	30,000		Stock Reserve		5,000
	Debtors	32,750	By	Goods Sent to Branch A/c		40,000
	Cash	5,000	By	Bank-Remittance		
To	Goods Sent to Branch A/c	2,40,000		received from the Branch		
To	Bank (Exp. paid by H.O.)	12,000		Cash sales	59,000	
To	Net Profit Transferred to H.O.			Drs. Collection	1,63,500	2,22,500
	Profit and Loss A/c	16,250		(Net of expense)		
To	Balance c/d (Stock reserve			(Rs. 2,22,500 –		
	on closing stock)	8,000		Rs. 59,000)		
			By	Balance c/d		
				Stock (including Transit)		48,000
				Debtors		26,000
				Cash		2,500
		3,44,000				3,44,000

(*c*) ***Double Column Method***: Without writing up a Branch Stock and a Branch Adjustment Account, it is also practicable to record all the relevant figures only in one account, by having two separate columns, one to show the value of goods sent out to branch at cost, entries wherein will be part of the double entry system and in second column memorandum entries in respect of the value of the same stock at the selling price. Under such a method, while the first column would disclose the amount of gross profit and the value of stock carried forward at cost the second column would not disclose profit or loss, but would balance by including therein the value of closing stock at selling price provided that there has been no physical loss of stocks.

This method is similar to the Memorandum Column Method for recording the value of goods sent out for sale on consignment basis both at the invoice and cost prices.

Illustration 6

Prepare Branch Account using the figures given in Illustration 4 following Double Column method :

Harrison Limited

New Delhi Branch Account

		Inv.	Cost			Inv.	Cost
		Rs.	Rs.			Rs.	Rs.
To	Balance b/d			By	Cash Sales	59,000	59,000
	Opening Stock	30,000	25,000	By	Credit Sales	1,65,000	1,65,000
To	Goods Sent to			By	Balance c/d		
	Branch A/c	2,40,000	2,00,000		Closing stock	48,000	40,000
To	Stock Adjustment A/c	2,000	1,667				
To	Gross Profit trans-						
	ferred to P&L A/c		37,333				
		2,72,000	2,64,000			2,72,000	2,64,000

Gross Profit = (Rs. 2,24,000 × 20/120) = Rs. 37,333.

Illustration 7

Sell Well Ltd. who carried on a retail business opened a branch X on January 1st, 2008 where all sales were on credit basis. All goods required by the branch were supplied from the Head Office and were invoiced to the branch at 10% above cost.

The following were the transactions:

	Jan. '08	Feb. 08	March '08
	Rs.	Rs.	Rs.
Goods sent to Branch (Purchase Price)	40,000	50,000	60,000
Sales as shown by the branch monthly report	38,000	42,000	55,000
Cash received from Debtors and remitted to H.O.	20,000	51,000	35,000
Returns to H.O. (Invoice price to Branch)	1,200	600	2,400

The stock of goods held by the branch on March 31, 2008 amounted to Rs. 53,400 at invoice to branch.

Record these transactions in the Head Office books, showing balances as on 31st March, 2008 and the branch gross profit for the three months ended on that date.

All workings should form part of your solution.

Solution

Books of Sell Well Ltd.

Branch Account

Dr.	*Rs.*			*Cr.* *Rs.*
To Goods sent to Branch A/c		By Cash-collected from debts		1,06,000
$\frac{110}{100}\times 1{,}50{,}000$	1,65,000	By Goods sent to Br.-returns		4,200
To Stock Reserve (W.N.2)	4,855	By Goods sent to Br. (W.N. 1)		14,618
To Balance Profit to General				
Profit & Loss A/c	37,363	By Balance c/d		
		Stock	53,400	
		Debtors	29,000	82,400
	2,07,218			2,07,218

Memorandum Branch Debtors Account

2008		Rs.	2008		Rs.
Jan. 1	To Balance b/d	-	Jan-		
Jan-				Mar. By	Cash/Bank
1,06,000					
Mar.	To Sales	1,35,000		By Balance c/d	29,000
		1,35,000			1,35,000

Goods Sent To Branch Account

	Rs.		Rs.
To Branch A/c (Returns)	4,200	By Branch A/c	1,65,000
To Branch A/c (Loading)	14,618		
To Purchases A/c	1,46,182		
	1,65,000		1,65,000

Working Notes:

Loading on Goods sent to Branch 1/11 of (Rs. 1,65,000 – Rs. 4,200) *i.e.* Rs. 1,60,800 = Rs. 14,618

Stock Reserve 1/11 of 53,400 = Rs. 4,855

Illustration 8

Hindustan Industries Mumbai has a branch in Cochin to which office goods are invoiced at cost plus 25%. The branch sells both for cash and on credit, Branch Expenses are paid direct from head office and the Branch has to remit all cash received into the Head Office Bank Account.

From the following details, relating to calendar year 2008, prepare the accounts in the Head Office Ledger and ascertain the Branch Profit. Branch does not maintain any books of account, but sends weekly returns to the Head Office:

	Rs.
Goods received from Head Office at invoice price	
6,00,000	
Returns to Head Office at invoice price	12,000
Stock at Cochin as on 1st Jan., 2008	60,000
Sales in the year - Cash	2,00,000
Credit	3,60,000

Sundry Debtors at Cochin as on 1st Jan. 2008	72,000
Cash received from Debtors	3,20,000
Discount allowed to Debtors	6,000
Bad Debts in the year	4,000
Sales returns at Cochin Branch	8,000
Rent, Rates, Taxes at Branch	18,000
Salaries, Wages, Bonus at Branch	60,000
Office Expenses	6,000
Stock at Branch on 31st Dec. 2008 at invoice price	1,20,000

Solution

Books of Hindustan Industries, Mumbai

Cochin Branch Stock Account

2008	Rs.	2008	Rs.
Jan. To Balance b/d	60,000	By Bank A/c (Cash sales)	2,00,000
To Goods sent to Branch A/c	6,00,000	By Branch Debtors (Cr. sales)	3,60,000
To Branch Debtors A/c		By Goods sent to Branch	
(sales return)	8,000	(Ret. to H.O.)	12,000
To Branch P & L A/c (surplus)	24,000	By Balance c/d (closing stock)	1,20,000
	6,92,000		6,92,000

Cochin Branch Stock Adjustment Account

2008	Rs.	2008	Rs.
To Goods sent to Branch A/c		Jan. By Balance b/d	
(1/5 of Rs. 12,000) (on returns)	2,400	(1/5 of Rs. 60,000)	12,000
To Branch P & L A/c (Profit on		By Goods sent to Br. A/c	
sale at invoice price)	1,05,600	(1/5 of Rs. 6,00,000)	1,20,000
To Balance c/d (1/5 of Rs. 1,20,000)	24,000		
	1,32,000		1,32,000

Goods sent to Branch Account

2008	Rs.	2008	Rs.
To Cochin Branch Stock Adjustment A/c	1,20,000	By Cochin Br. Stock A/c	6,00,000
To Cochin Br. Stock A/c (Ret.)	12,000	By Cochin Br. Stock Adj. A/c	2,400
To Purchases A/c	4,70,400		
	6,02,400		6,02,400

Branch Debtors Account

2008		Rs.	2008		Rs.
Jan. To Balance b/d		72,000	By Bank		3,20,000
To Branch Stock A/c		3,60,000	By Branch P & L A/c		
			By Discount	6,000	
			By Bad Debts	4,000	10,000
			By Branch Stock (Sales Ret.)		8,000
			By Balance c/d		94,000
		4,32,000			4,32,000

Bank Expenses Account

	Rs.		Rs.
To Bank A/c (Rent, Rates & Taxes)	18,000	By Branch Profit & Loss A/c (Transfer)	84,000
To Bank A/c (Salaries & Wages)	60,000		
To Bank A/c (office exp.)	6,000		
	84,000		84,000

Branch Profit & Loss Account for the year ending 31st Dec. 2008

		Rs.		Rs.
To Branch Expenses A/c		84,000	By Branch Stock Adj. A/c	1,05,600
Discount	6,000		By Branch stock A/c	
Bad debts	4,000	10,000	(Sale over invoice price)	24,000
To Net Profit to Profit & Loss A/c		35,600		
		1,29,600		1,29,600

Illustration 9

Arnold Ltd. Delhi, trades in Ghee and Oil. It has a branch at Lucknow. The company dispatches 25 tins of Oil @ Rs.1,000 per tin and 15 tins of Ghee @ Rs.1,500 per tin on 1st of every month. The branch incurs some expenditure which is met out of its collections; this is in addition to expenditure directly paid by Head Office.

Following are the other details:

		Delhi	*Lucknow*
		Rs.	*Rs.*
Purchases	Ghee	14,75,000	-
	Oil	29,32,000	-
Direct expenses		3,83,275	-
Expenses paid by H.O.		-	14,250
Sales	Ghee	18,46,350	3,42,750
	Oil	27,41,250	3,15,730
Collection during the year (including Cash Sales)		-	6,47,330
Remittance by Branch to Head Office		-	6,13,250

	(Delhi)	
Balance as on:	1-1-2008	31-12-2008
Stock : Ghee	1,50,000	3,12,500
Oil	3,50,000	4,17,250
Debtors	7,32,750	-
Cash on Hand	70,520	55,250
Furniture & Fittings	21,500	19,350
Plant/Machinery	3,07,250	7,73,500

	(Lucknow)	
Balance as on:	1-1-2008	31-12-2008
Stock : Ghee	17,000	13,250
Oil	27,000	44,750
Debtors	75,750	-

Cash on Hand	7,540	12,350
Furniture & Fittings	6,250	5,625
Plant/Machinery	-	-

Addition to Plant/Machinery on 1-1-2008 Rs. 6,02,750.

Rate of Depreciation: Furniture / Fittings @ 10% and Plant / Machinery @ 15% (already adjusted in the above figures).

The Branch Manager is entitled to 10% commission after charging such commission whereas, the General Manager is entitled to 10% commission on overall company profits after charging such commission. General Manager is also entitled to a salary of Rs. 2000 p.m. General expenses incurred by H.O. Rs. 24,000.

Prepare Branch Account in the head office books and also prepare the company's Trading and Profit and Loss A/c (excluding branch transactions).

Solution

In the Books of Arnold Ltd.

Lucknow Branch Account

Dr.			*Cr.*
	Rs.		*Rs.*
To Balance b/d		By Bank (Remittance to H.O.)	6,13,250
Opening stock:		By Balance c/d	
Ghee	17,000	Closing stock:	
Oil	27,000	Ghee	13,250
Debtors	75,750	Oil	44,750
Cash on hand	7,540	Debtors (W.N. 1)	86,900
Furniture & fittings	6,250	Cash on hand (W.N. 2)	12,350
To Goods sent to Branch A/c		Furniture & fittings	5,625
Ghee	2,70,000		
Oil	3,00,000		
To Bank (Expenses paid by H.O.)	14,250		
To Branch Manager			
Commission (Rs. 58,335 × 1/11)	5,303		

To Net Profit Transferred					
to General P & L A/c		53,032			
		7,76,125			7,76,125

Arnold Ltd.

Trading and Profit and Loss account for the year ended 31st December, 2008

(Excluding branch transactions)

		Rs.		Rs.
To Opening Stock:			By Sales:	
Ghee		1,50,000	Ghee	18,46,350
Oil		3,50,000	Oil	27,41,250
To Purchases:			By Closing Stock:	
Ghee	14,75,000		Ghee	3,12,500
Less: Goods sent			Oil	4,17,250
to Branch	2,70,000	12,05,000		
Oil	29,32,000			
Less: Goods sent				
to Branch	3,00,000	26,32,000		
To Direct Expenses		3,83,275		
To Gross Profit		5,97,075		
		53,17,350		53,17,350
To Manager's Salary		24,000	By Gross Profit	5,97,075
To General Expenses		24,000	By Branch Profit transferred	53,032
To Depreciation				
Furniture @ 10%	2,150			
Plant & Machinery				
@ 15%	1,36,500	1,38,650		
To General Manager's				
Commission @ 10%				
i.e., 4,63,457 × 1/11		42,132		
To Net profit		4,21,325		
		6,50,107		6,50,107

Working Notes :

(1) Debtors Account

Dr.					Cr.
			Rs.		*Rs.*
1-1-08	To	Balance b/d	75,750	By Cash Collections	6,47,330
	To	Sales made during the year:		31-12-08 By Balance c/d	86,900
		Ghee	3,42,750		
		Oil	3,15,730		
			7,34,230		7,34,230

(2) Branch Cash A/c

			Rs.		Rs.
1-1-08	To	Balance b/d	7,540	By Remittance	6,13,250
	To	Collections	6,47,330	By Exp. (Balance fig.)	29,270
				31-12-08 By Balance c/d	12,350
			6,54,870		6,54,870

3.3 Goods invoiced at wholesale price to retail branches: When retail branches (Shops) are started by manufacturers, the profit properly attributable to such shops is the difference between the sale proceeds of goods at the shops and the wholesale price of the goods sold. For the purpose, it is assumed that the manufacturer would always be able to sell the goods on wholesale terms and thereby realise profit equal to the difference between the wholesale price and the cost. Many concerns, therefore, invoice, goods to such shops at wholesale price and determine profit or loss on sale of goods on this basis. Accordingly, Branch Stock Account or the Trading Account is debited with:

(*a*) the value of opening stock at the Branch; and

(*b*) price of goods sent during the year at wholesale price.

It is credited by:

(*a*) sales effected at the shop; and

(*b*) closing stock of goods valued at wholesale price.

The value of goods lost due to accident, theft etc. also is credited to the Branch Stock Account or Trading Account calculated at the wholesale price. At this stage, the Branch Stock or Trading Account will reveal the amount of gross profit (or loss). It is transferred to the Branch

Profit and Loss Account. On further being debited with the expenses incurred at the shop (including any allowance that may have been made in favour of a customer after sales being recorded) and the wholesale price of goods lost, the Branch Profit and Loss Account will disclose the net profit (or loss) at the shop.

Since the closing stock at the branch has to be valued at wholesale price, it would be necessary to create a stock reserve equal to the difference between its wholesale price and its cost (to the head office) by debiting the amount in the *Head Office Profit and Loss Account.* This Stock Reserve is carried down to the next year and then transferred to the credit of the (Head Office) Profit and Loss Account.

4. INDEPENDENT BRANCHES

Independent branches maintain comprehensive account books for recording their transactions; therefore a separate trial balance of each branch can be prepared. The head office maintains one ledger account for each such branch, wherein all transactions between the head office and the branches are recorded. The head office A/c in branch books and Branch A/c in head office books should tie up whereby completeness of recording of transactions can be ensured.

	Transactions	**Head office books**		**Branch books**	
(*i*)	Dispatch of goods to branch by H.O.	Branch A/c To Good sent to Branch A/c	Dr.	Goods received. from H.O. A/c To Head Office A/c	Dr.
(*ii*)	When goods are returned by the Branch to H.O.	Goods sent to Branch A/c To Branch A/c	Dr.	Head Office A/c To Goods recd. from H.O. A/c	Dr.
(*iii*)	Branch Expenses are paid by the Br.	No Entry		Expenses A/c To Cash A/c	Dr.
(*iv*)	Branch Expenses paid by H.O.	Branch A/c To Bank	Dr.	Expenses A/c To Head Office A/c	Dr.
(*v*)	Outside purchases made by the Br.	No Entry		Purchases A/c To Bank (or) Crs. A/c	Dr.
(*vi*)	Sales effected by the Branch	No Entry		Cash or Debtors A/c To Sales	Dr.

(*vii*)	Collection from Debtors of the Br. recd. by H.O.	Cash or Bank A/c To Branch A/c	Dr.	Head office A/c To Sundry Drs. A/c	Dr.
(*viii*)	Payment by H.O. for purchase made by Br.	Branch A/c To Bank	Dr.	Purchase (or) Sundry Creditors A/c To Head Office	Dr.
(*ix*)	Purchase of Asset by Branch	No Entry		Sundry Assets To Bank (or) Liability	Dr.
(*x*)	Asset purchased by the Br. but Asset A/c retained at H.O. books	Branch Asset A/c To Branch A/c	Dr.	Head office To Bank (or) Liability	Dr.
(*xi*)	Depreciation on (*x*) above	Branch A/c To Branch Asset	Dr.	Depreciation A/c To Head Office A/c	Dr.
(*xii*)	Remittance of funds by H.O. to Branch	Branch A/c To Bank	Dr.	Bank A/c To Head Office	Dr.
(*xiii*)	Remittance of funds by Branch to H.O.	Reverse entry of(*xii*) above		Reverse entry of (*xii*) above	
(*xiv*)	Transfer of goods from one Branch to another branch	(Recipient) Br. A/c To Supplying Branch A/c	Dr.	Supplying Br. H.O. A/c To Goods Received from H.O. A/c Recipient Branch Goods Received from H.O. A/c To Head Office A/c	Dr. Dr.

Students may find a few further practical situations and it is hoped that they can pass entries on the basis of accounting principles explained above.

The final result of these adjustments will be that so far as the Head Office is concerned, the branch will be looked upon either as a debtor or creditor, as a debtor if the amount of its assets is in excess of its liabilities and as a creditor if the position is reverse. A debit balance in the Branch Account should always be equal to the net assets at the branch. The important thing to remember, when independent sets of accounts are maintained, is that the branch and head office books are connected with each other only through the medium of the Branch and the Head Office Account of their component which are converse of each other. Therefore, whatever adjustments have to be made must be passed only through them; also when accounts of the branch and head office are consolidated both the Branch and Head Office Accounts will be eliminated.

5. ADJUSTMENT AND RECONCILIATION OF BRANCH AND HEAD OFFICE ACCOUNTS

If the branch and the head office accounts, converse of each other, do not tally, these must be reconciled before the preparation of the final accounts of the concern as a whole.

It is very important to note that the Balance of Head Office A/c in Branch books and Branch A/c in Head Office books are tallied before financial statements are prepared.

The point at which an action has been effected should be taken as the basis and the other point should adjust its books on the basis of the transaction effected at the other end. In Accounting language, if Head Office has sent goods worth Rs.50,000 but the branch has received till the closing date goods only Rs.40,000, then the branch should treat Rs.10,000 as goods in transit and should pass the following entry :

		Dr.	Cr.
Goods in transit A/c	Dr.	10,000	
To Head Office A/c			10,000

However, there will be no entry in Head office books being the point where the event has been recorded in full, hence no further entries in Head office books.

5.1 Reasons for Disagreement: Following are the possible reasons for the disagreement between Branch A/c in Head office books and Head office A/c in Branch books on the closing date:

Goods dispatched by the Head office not received by the branch. These goods may be in transit or loss in transit.

Goods returned by the branch to Head Office may have been received by the H.O. Again, these goods may be in transit or lost in transit.

Sum remitted by Head office to branch or *vice versa* remaining in transit on the closing date.

Receipt of income or payment or expenses relating to the Branch transacted by the head office or *vice versa*, hence not recorded at the respective ends wherein they are normally to be recorded.

The technique of reconciliation has been illustrated through the example given below :

	Head office		Branch	
	Dr.	Cr.	Dr.	Cr.
Goods sent to Branch		1,50,000	-	
Goods recd. from H.O. A/c		-	1,40,000	
Branch A/c	1,12,000			
Head office A/c	-	-	-	78,500

On analysis of Branch A/c in Head office books and Head office A/c in branch books, you find :

Rs.15,000 remitted by the branch has not been received, hence not recorded in the head office books.

Direct collection of Rs.10,500 from a customer of the branch by Head office not informed to the branch, hence not recorded by the branch.

A sum of Rs.14,500 paid by branch to the suppliers of head office not recorded at Head office.

Head office expenditure allocation to the branch Rs.12,000 not recorded in the branch.

Rs.7,500 being FD interest of head office received by the branch on oral instructions from H.O., not recorded in the head office books.

			Head Office Books			**Branch Books**	
			Dr.	Cr.		Dr.	Cr.
			Rs.	Rs.		Rs.	Rs.
(*i*)	*Goods in transit* (Rs. 10,000)		-	-	Goods in Transit A/c	10,000	
					To Head office A/c		10,000
(*ii*)	*Cash in Transit* :	Cash in Transit A/c	15,000		(No Entry)		
		To Branch A/c		15,000			
(*iii*)	*Direct Collection by*				Head Office A/c	10,500	
	H.O. on behalf of the Branch				To Debtors A/c		10,500

(*iv*)	*Direct payment of Rs. 14,500 by Branch on*	Sundry Crs. A/c	14,500				
	behalf of H.O	To Branch A/c		14,500			
(*v*)	*Expenditure Allocated to Branch*				Branch Exp. A/c	12,000	
					To H.O. A/c		12,000
(*vi*)	*Fixed Deposit interest*	Branch A/c	7,500				
	of Rs. 7,500 directly received by the Branch	To Sundry Income		7,500			

In Branch Books

Head Office Account

Dr.			Cr.
	Rs.		Rs.
To Sundry Debtors A/c	10,500	By Balance b/d	78,500
To Balance c/d	90,000	By Goods in transit	10,000
		By Branch expenses	12,000
	1,00,500		1,00,500
		By Balance b/d	90,000

In the Books of Head Office

Branch A/c

Dr.			Cr.
	Rs.		Rs.
To Balance b/d	1,12,000	By Cash in Transit	15,000
To Sundry Income	7,500	By Sundry Creditors	14,500
		By Balance c/d	90,000
	1,19,500		1,19,500
To Balance b/d	90,000		

Students may note (*i*) the balance of Head Office A/c in Branch books and Branch A/c in Head Office books have tallied (*ii*) Adjustment are made only at the point:

Where the recording has been omitted, and

Other than the point where action has been effected.

5.2 Other points: (1) Inter-branch transactions are usually adjusted as if they were entered into only with the head office. It is a very convenient method of treating such transaction especially where the number of branches are large. Suppose Kolkata Branch incurred an expenditure on advertisement of Rs.1,000 on account of Delhi Branch, the entries that would be made in such a case would be as follows:

		Dr.	Cr.
		Rs.	Rs.
In Kolkata Books:			
Head Office A/c	Dr.	1,000	
To Cash			1,000
In Delhi Books:			
Advertisement A/c	Dr.	1,000	
To H.O. A/c			1,000
In H.O. Books:			
Delhi Branch A/c	Dr.	1,000	
To Kolkata Branch A/c			1,000

(2) Often the accounts of fixed assets of a branch are kept in the head office books; in such a case, at the end of the year, the amount of depreciation on the assets is debited to the branch concerned by recording the following entry:

Branch Account Dr.

To Branch Asset Account

The branch will pass the following entry:

Depreciation Account Dr.

To Head Office A/c

(3) Usually the head office has to devote considerable time in attending to the affairs of the branch; on that account, it may decide to raise a charge against the branch in respect of the cost of such time. In such a case the amount is debited to the branch as 'Expenses' and is credited to appropriate revenue head such as Salaries Accounts, General Charges Account, Entertainment Account etc. The branch credits the H.O. Account and debits Expenses Account.

6. INCORPORATION OF BRANCH BALANCE IN HEAD OFFICE BOOKS

The method that will be adopted for incorporating the trading result of the branch with that of the head office would depend on whether it is desired to prepare separate Profit & Loss Account and Balance Sheet of the branch and the Head Office or consolidated statement of account of both branch and head office.

In the first-mentioned case, the amount of profit or loss shown by the Profit & Loss Account of the branch only will be transferred to Head office Account in the branch books and a converse entry will be passed in the Head Office books by debit to the Branch Account. This method has already been illustrated above. In such a case, not only the Profit & Loss Account of the branch and that of the head office would be prepared separately but also there would be separate Balance Sheet for the branch and the head office. The branch Balance Sheet would show the amount advanced by the head office to it, as capital. In the head office Balance Sheet, the same amount would be shown as an advance to the branch.

If however, it is desired to prepare a consolidated Profit & Loss Account and Balance Sheet, individual balances of all the revenue accounts would be separately transferred to the Head Office Account by debit or credit in the branch books and the converse entries would be passed in the head office books. The effect thereof will be similar to the amount of net profit or loss of the branch having been transferred since it would be composed of the balances that have been transferred. In case it is also desired that consolidated balance sheet of the branch and the head office should be prepared, it will also be necessary to transfer the balance of assets and liabilities of the branch to the head office. The adjusting entries that would be passed in this respect are shown below:

(*a*)	Head Office Account	Dr.
	To (individual) Asset Account	
(*b*)	(Individual) Liability Account	Dr.
	To Head Office Account	

Converse entries are passed in the head office books.

It is obvious that after afore-mentioned entries have been passed, the Branch Account in the Head Office books and Head Office Account in the branch books will be closed and it will be necessary to restart them at the beginning of the next year.

In consequence, at the beginning of the following year, the under-mentioned entry is recorded by the branch:

Asset Account (In Detail)	Dr.
To Liability Accounts	
To H.O. Account (The difference between assets and liabilities)	

Illustration 10

Messrs Ramchand & Co., Hyderabad have a branch in Delhi. The Delhi Branch deals not only in the goods from Head Office but also buys some auxiliary goods and deals in them. They, however, do not prepare any Profit & Loss Account but close all accounts to the Head Office at the end of the year and open them afresh on the basis of advice from their Head Office. The fixed assets accounts are also maintained at the Head Office.

The goods from the Head Office are invoiced at selling prices to give a profit of 20 per cent on the sale price. The goods sent from the branch to Head Office are at cost. From the following prepare the Branch Account, Branch Trading and Profit & Loss Account and Branch Assets Account in the Head Office Books.

Trial Balance of the Delhi Branch as on 31-12-2008

Debit	Rs.	**Credit**	Rs.
Head office opening balance 1-1-08	15,000	Sales	1,00,000
Goods from H.O.	50,000	Goods to H.O.	3,000
Purchases	20,000	Head Office Current A/c	15,000
Opening Stock (H.O. goods at invoice prices)	4,000	Sundry Creditors	3,000
Opening Stock of other goods	500		
Salaries	7,000		
Rent	3,000		
Office expenditure	2,000		
Cash on Hand	500		
Cash at Bank	4,000		
Sundry Debtors	15,000		
	1,21,000		1,21,000

The Branch balances as on 1st January, 2008, were as under: Furniture Rs.5,000; Sundry Debtors Rs.9,500; Cash Rs.1,000, Creditors Rs.30,000; Stock (H.O. goods at invoice price) Rs.4,000; other goods Rs.500. The closing stock at branch of the head office goods at invoice price is Rs.3,000 and that of purchased goods at cost is Rs.1,000. Depreciation is to be provided at 10 per cent on branch assets.

Solution

Delhi Branch

Branch Trading and Profit & Loss Account

for the year ended 31st Dec., 2008

Dr.			Cr.		
		Rs.			Rs.
To Opening Stock:			By Sales		1,00,000
Head office Goods	3,200		By Goods from Branch		3,000
Others	500	3,700	By Closing Stock :		
To Goods (To Branch)		40,000	Head Office goods	2,400	
To Purchases		20,000	Others	1,000	3,400
To Gross Profit c/d		42,700			
		1,06,400			1,06,400
To Salaries		7,000	By Gross profit b/d		42,700
To Rent		3,000			
To Office Expenses		2,000			
To Dep. on furniture @ 10%		500			
To Net profit		30,200			
		42,700			42,700

Branch (Fixed) Assets Account (In Head Office Books)

2008		Rs.	2008		Rs.
Jan. 1	To Balance b/d	5,000	Dec. 31	By Delhi Branch A/c (Depreciation)	500
				By Balance c/d	4,500
		5,000			5,000
2009					
Jan. 1	To Balance b/d	4,500			

Cash/Bank Account (Branch Books)

	Rs.	Rs.		Rs.
To Balance b/d		1,000	By Salaries	7,000
To Sales Proceeds		94,500	By Rent	3,000
Sales	1,00,000		By Office Exp.	2,000
Opening balance			By Creditors*	47,000
of Debtors	9,500		By Head Office (Balancing fig.)	32,000
	1,09,500		By Cash Balance	500
Less: Closing balance	15,000		By Bank Balance	4,000
Cash Received	94,500			
		95,500		95,500

*Opening Balance + Purchases – Closing balance = Payment

Rs. 30,000 + Rs. 20,000 – Rs. 3,000 = Rs. 47,000.

Trial Balance of Delhi Branch as on 1-1-2008

			Dr.	Cr.
			Rs.	Rs.
Debtors			9,500	
Cash			1,000	
Stock	H.O. Goods	4,000		
	Others	500	4,500	
Creditors				30,000
Head Office Account			15,000	
			30,000	30,000

Head Office Account

2008			
Jan. 1	Rs.		Rs.
To Balance (transfer)	15,000	By Goods from Head Office	50,000
To Cash	32,000		
To Goods sent	3,000		
	50,000		50,000

Credit balance in Head Office Account before this transfer will be Rs. 15,000 credit.

Note : Furniture A/c is maintained in Head office books; it is not a part of either opening or closing balance.

Illustration 11

Ring Bell Ltd. Delhi has a Branch at Bombay where a separate set of books is used. The following is the trial balance extracted on 31st December, 2008.

Head Office Trial Balance

	Rs.	Rs.
Share Capital (Authorised: 10,000 Equity Shares of Rs. 100 each):		
Issued: 8,000 Equity Shares		8,00,000
Profit & Loss Account - 1-1-2008		25,310
Interim Dividend paid - Aug. 2008	30,000	
General Reserve		1,00,000
Fixed Assets	5,30,000	
Stock	2,22,470	
Debtors and Creditors	50,500	21,900
Profit for 2008		82,200
Cash Balance	62,730	
Branch Current Account	1,33,710	
	10,29,410	10,29,410

Branch Trial Balance

	Rs.	Rs.
Fixed Assets	95,000	
Profit for 2008		31,700
Stock	50,460	
Debtors and Creditors	19,100	10,400
Cash Balance	6,550	
Head Office Current Account	———	1,29,010
	1,71,110	1,71,110

The difference between the balances of the Current Account in the two sets of books is accounted for as follows:

(*a*) Cash remitted by the Branch on 31st December, 2008, but received by the Head Office on 1st January 2009 - Rs. 3,000.

(*b*) Stock stolen in transit from Head Office and charged to Branch by the Head Office, but not credited to Head Office in the Branch books as the Branch Manager declined to admit any liability (not covered by insurance) - Rs. 1,700.

Give the Branch Current Account in Head Office books after incorporating Branch Trial Balance through journal. Also prepare the company's Balance Sheet as on 31st December, 2008.

Solution

The Branch Current Account in the Head Office Books and Head Office Current Account in the Branch Books do not show the same balances. Therefore, in order to reconcile them, the following journal entries will be passed in the Head Office books :

Journal

			Dr.	Cr.
2008			Rs.	Rs.
Dec., 31	Cash in Transit A/c	Dr.	3,000	
	To Branch Current A/c			3,000
	(Cash sent by the Branch on 31st Dec., 2008 but received at H.O. on Ist Jan., 2009)			

Loss by theft A/c	Dr.	1,700	
To Branch Current A/c			1,700
(Stock lost in transit from H.O. to Branch)			

In order to incorporate, in the H.O. books, the given Branch trial balance which has been drawn up after preparing the Branch Profit & Loss Account, the following journal entries will be necessary:

Journal

2008			Rs.	Rs.
Dec. 31	Branch Current Account	Dr.	31,700	
	To Profit & Loss Account			31,700
	(Branch Profit for 2008)			
	Branch Fixed Assets	Dr.	95,000	
	Branch Stock	Dr.	50,460	
	Branch Debtors	Dr.	19,100	
	Branch Cash	Dr.	6,550	
	To Branch Current Account			1,71,110
	(Branch assets brought into H.O. Books)			
	Branch Current A/c	Dr.	10,400	
	To Branch Creditors			10,400
	(Branch creditors brought into H.O. Books)			

Branch Current Account

Dr.	Rs.	Cr.	Rs.
To Balance b/d	1,33,710	By Cash in transit	3,000
To Profit & Loss A/c	31,700	By Loss of theft	1,700
To Branch Creditors	10,400	By Sundry Branch Assets	1,71,110
	1,75,810		1,75,810

Profit and Loss Account for 2008

	Rs.			Rs.
To Loss by Theft	1,700	By Balance b/d		25,310
To Interim Dividend for Aug., 2005	30,000	By Year's Profit :	H.O.	82,200
To Balance c/d	1,07,510		Branch	31,700
	1,39,210			1,39,210

Balance Sheet of the Company as on 31st Dec., 2008

Liabilities		*Rs.*	*Assets*		*Rs.*
Authorised capital :			Fixed Assets :		
10,000 Equity Shares of			H.O.	5,30,000	
Rs. 100 each		10,00,000	Branch	95,000	6,25,000
Issued and Subscribed			Stock :		
Capital : 8,000 Equity			H.O.	2,22,470	
Shares of Rs. 100 each			Branch	50,460	2,72,930
Fully paid		8,00,000	Debtors :		
General Reserve		1,00,000	H.O.	50,500	
Profit & Loss Account		1,07,510	Branch	19,100	69,600
Creditors :			Cash in Hand :		
H.O.	21,900		H.O.	62,730	
Branch	10,400	32,300	Branch	6,550	69,280
			Cash in Transit		3,000
		10,39,810			10,39,810

Illustration 12

KP Ltd. manufactures a range of goods which it sells to wholesale customers only from its head office. In addition, the H.O. transfers goods to a newly opened branch at factory cost *plus* 15%. The branch then sells these goods to the general public on only cash basis.

The selling price to wholesale customers is designed to give a factory profit which amounts to 30% of the sales value. The selling price to the general public is designed to give a gross margin (*i.e.,* selling price less cost of goods from H.O.) of 30% of the sales value.

The company operates from rented premises and leases all other types of fixed assets. The rent and hire charges for these are included in the overhead costs shown in the trial balances.

From the information given below, you are required to prepare for the year ended 31st Dec., 2008 in columnar form.

(*a*) A Profit & Loss account for (*i*) H.O. (*ii*) the branch (*iii*) the entire business.

(*b*) Balance Sheet as on 31st Dec., 2008 for the entire business.

	H.O. Branch		Branch	
	Rs.	Rs.	Rs.	Rs.
Raw materials purchased	35,000			
Direct wages	1,08,500			
Factory overheads	39,000			
Stock on 1-1-2008				
Raw materials	1,800			
Finished goods	13,000		9,200	
Debtors	37,000			
Cash	22,000		1,000	
Administrative Salaries	13,900		4,000	
Salesmen's Salaries	22,500		6,200	
Other administrative & selling overheads	12,500		2,300	
Inter-unit accounts	5,000			2,000
Capital		50,000		
Sundry Creditors		13,000		
Provision for Unrealised profit in stock		1,200		
Sales		2,00,000		65,200
Goods sent to Branch		46,000		
Goods Received from H.O.			44,500	
	3,10,200	3,10,200	67,200	67,200

Notes:

(1) On 28th Dec., 2008 the branch remitted Rs.1,500 to the H.O. and this has not yet been recorded in the H.O. books. Also on the same date, the H.O. dispatched goods to the branch invoiced at Rs.1,500 and these too have not yet been entered into the branch books. It is the company's policy to adjust items in transit in the books of the recipient.

(2) The stock of raw materials held at the H.O. on 31st Dec., 2008 was valued at Rs.2,300.

(3) You are advised that:

there were no stock losses incurred at the H.O. or at the branch.

it is the company's practice to value finished goods stock at the H.O. at factory cost.

there were no opening or closing stock of work-in-progress.

(4) Branch employees are entitled to a bonus of Rs. 156 under a bilateral agreement.

Solution

K.P. Ltd.

Trading and Profit & Loss Account for the year ended 31st Dec., 2008

	H.O.	Branch	Total		H.O.	Branch	Total
	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
To Material consumed	34,500			By Sales	2,00,000	65,200	2,65,200
” Wages	1,08,500			” Goods Sent to Branch	46,000		
” Factory Overheads	39,000			” Closing stock	15,000	9,560	24,560
” Factory cost	1,82,000		1,82,000				
” Opening stock of finished goods	13,000	9,200	22,200				
	1,95,000						
” Goods from H.O.		46,000					
” Gross Profit	66,000	19,560	85,560				
	2,61,000	74,760	2,89,760		2,61,000	74,760	2,89,760

	H.O.	Branch	Total		H.O.	Branch	Total
To Admn. Salaries	13,900	4,000	17,900	By Gross Profit	66,000	19,560	85,560
" Salesmen Salaries	22,500	6,200	28,700				
" Other Admn. & Overheads	12,500	2,300	14,800				
" Stock Reserve (increase)	47	-	47				
Bonus to Staff	-	156	156				
" Net Profit	17,053	6,904	23,957				
	66,000	19,560	85,560		66,000	19,560	85,560

Balance Sheet as on 31st Dec., 2008

		H.O.	Branch	Total		H.O.	Branch	Total
	Rs.	Rs.	Rs.	Rs.		Rs.	Rs.	Rs.
Capital		50,000	-	50,000	Fixed Assets	-	-	-
Profit : H.O.	17,053				Current Assets			
Branch	6,904	23,957		23,957	Raw material	2,300		2,300
Trade Creditors		13,000		13,000	Finished Goods (Less Stock Res.)	15,000	9,560	23,313*
Bonus Payable			156	156				
H.O. Account			10,404		Debtors	37,000	-	37,000
Stock Reserve		1,247			Cash (including transit item)	23,500	1,000	24,500
					Branch A/c	10,404**		
		88,204	10,560	87,113		88,204	10,560	87,113

*9,560 × 100/115 *i.e.,* 8,313 + 15,000 = 23,313

** 5,000 + 6,904 – 1500 = 10,404.

7. INCOMPLETE INFORMATION IN BRANCH BOOKS

If it is desired that profitability of the branch should be kept secret from the branch staff, the head office would hold back some key information from the branch, e.g., amount of opening stock, cost of goods sent to the branch, etc. The head office, in such a case would maintain a record of goods sent to the branch by passing the entry:

Goods Supplied to the Branch Account Dr.

To Purchases Account

The value of the closing stock will also be adjusted only in head office books.

In such a case, for closing its books at the end of the year, the branch will simply transfer various revenue accounts to the head office without drawing up a Trading and Profit & Loss Account.

On that basis, supplemented by the record of transactions maintained at the head office, it will be possible to construct the Trading and Profit & Loss Account of the branch.

Illustration 13

AFFIX Ltd. of Kolkata has a branch at Delhi to which the goods are supplied from Kolkata but the cost thereof is not recorded in the Head Office books. On 31st March, 2008 the Branch Balance Sheet was as follows :

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors Balance	40,000	Debtors Balance	2,00,000
Head Office	1,68,000	Building Extension A/c closed by transfer to H.O. A/c	
		Cash at Bank	8,000
	2,08,000		2,08,000

During the six months ending on 30-9-2008, the following transactions took place at Delhi.

	Rs.		*Rs.*
Sales	2,40,000	Manager's Salary	4,800
Purchases	48,000	Collections from Debtors	1,60,000
Wages paid	20,000	Discounts allowed	8,000
Salaries (inclusive of advance of Rs. 2,000)	6,400	Discount earned	1,200
		Cash paid to Creditors	60,000
General Expenses	1,600	Building Account (further payment)	4,000
Fire Insurance (paid for one year)	3,200	Cash in Hand	1,600
Remittance to H.O.	38,400	Cash at Bank	28,000

Set out the Head Office Account in Delhi books and the Branch Balance Sheet as on 30-9-2008. Also give journal entries in the Delhi books.

Solution

Journal

2008		Dr.	Cr.
30 Sept.		Rs.	Rs.
Salary Advance A/c	Dr.	2,000	
To Salaries A/c			2,000
(The amount paid as advance adjusted by debit to Salary Advance Account)			
Prepared Insurance A/c	Dr.	1,600	
To Fire Insurance A/c			1,600
(Six months premium transferred to the Prepaid Insurance A/c)			
Head Office Account	Dr.	88,400	
To Purchases A/c			48,000
To Wages A/c			20,000
To Salaries A/c			4,400
To General Expenses A/c			1,600
To Fire Insurance A/c			1,600
To Manager's Salary A/c			4,800
To Discount Allowed A/c			8,000
(Transfer of various revenue accounts (Dr.) to the H.O. Account for closing the accounts)			
Sales Accounts	Dr.	2,40,000	
Discount Earned A/c	Dr.	1,200	
To Head Office A/c			2,41,200
[Revenue accounts (cr) transferred to H.O.]			
Head Office Account	Dr.	4,000	
To Building Account			4,000
(Transfer of amounts spent on building extension to H.O. A/c)			

Head Office Account

Dr.						Cr.
2008		Rs.	2008			Rs.
Sep. 30	To Cash-remittance	38,400	April 1	By	Balance b/d	1,68,000
	" Sundries (Revenue A/cs)	88,400	Sep. 30	"	Sundries (Revenue A/cs)	2,41,200
	" Building A/c	4,000				
	" Balanced c/d	2,78,400				
		4,09,200				4,09,200

Balance Sheet of Delhi Branch as on Sept. 30, 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Creditors Balances	26,800	Debtors Balances	2,72,000
Head Office Account	2,78,400	Salary Advance	2,000
		Prepaid Insurance	1,600
		Building Extension A/c transferred to H.O.	—
		Cash in Hand	1,600
		Cash at Bank	28,000
	3,05,200		3,05,200

Cash and Bank A/c

Dr.					Cr.
31st March 2008					
To	Balance b/d	8,000	By	Wages	20,000
"	Collection from Drs.	1,60,000	"	Salaries	6,400
			"	Insurance	3,200
			"	General Exp.	1,600
			"	H.O. A/c	38,400
			"	Manager's Salary	4,800
			"	Creditors	60,000
			"	Building A/c	4,000

			”	Balance c/d			
				Cash in Hand	1,600		
				Cash at Bank	28,000	29,600	
		1,68,000				1,68,000	

Debtors Account

March 2008			Sept. 2006		
To	Balance b/d	2,00,000	By	Cash Collection	1,60,000
Sept. 2008			”	Discount (allowed)	8,000
”	Sales	2,40,000	By	Balance c/d	2,72,000
		4,40,000			4,40,000
1 Oct. 2008					
”	Balance b/d	2,72,000			

Creditors Account

Sept. 2008					
To	Cash	60,000	March 2008		
”	Discount (earned)	1,200	By	Balance b/d	40,000
			Sept. 2008		
To	Balance c/d	26,800	By	Purchases	48,000
		88,000			88,000
			1, Oct. 2008		
			By	Balance b/d	26,800

Illustration 14

The following Trial balances as at 31st December, 2008 have been extracted from the books of Major Ltd. and its branch at a stage where the only adjustments requiring to be made prior to the preparation of a Balance Sheet for the undertaking as a whole.

	Head Office		Branch	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	Rs.	*Rs.*	*Rs.*	*Rs.*
Share Capital		1,50,000		
Sundry Fixed Assets	75,125		18,901	
Sundry Current Assets	1,21,809		23,715	(Note 3)
Sundry Current Liabilities		34,567		9,721
Stock Reserve, 1st Jan., 2008				
(Note 2)		693		
Revenue Account		43,210		10,250
Branch Account	31,536			
Head Office Account				22,645
	2,28,470	2,28,470	42,616	42,616

Notes :

1. Goods transferred from Head Office to the Branch are invoiced at cost plus 10% and both Revenue Accounts have been prepared on the basis of the prices charged.
2. Relating to the Head Office goods held by the Branch on 1st January, 2008.
3. Includes goods received from Head Office at invoice price Rs.4,565.
4. Goods invoiced by Head Office to Branch at Rs.3,641 were in transit at 31st December, 2008, as was also a remittance of Rs.3,500 from the Branch.
5. At 31st December, 2008, the following transactions were reflected in the Head Office books but unrecorded in the Branch books.

The purchase price of lorry, Rs.2,500, which reached the Branch on December 25; a sum received on December 30, 2008 from one of the Branch debtors, Rs.750.

You are required:

(*i*) to record the foregoing in the appropriate ledger accounts in both sets of books;

(*ii*) to prepare a Balance Sheet as at 31st December, 2008 for the undertaking as a whole.

Solution

H.O. Books

Branch Account

2008			*Rs.*	*2008*			*Rs.*
Dec. 31	To	Balance b/d	31,536	Dec. 31	By	Cash in transit	3,500
					"	Balance b/d	28,036
			31,536				31,536

Cash in Transit Account

			Rs.				Rs.
2008				2008			
Dec. 31	To	Branch A/c	3,500	Dec. 31	By	Balance c/d	3,500

Stock Reserve Account

2008			Rs.	2008			Rs.
Dec. 31	To	Balance c/d	746	Jan. 1	By	Balance c/d	693
					"	Reserve A/c	53
			746				746

Revenue Account

2008			Rs.	2008			Rs.
Dec. 31	To	Stock Reserve	53	Dec. 31	By	Balance c/d	43,210
	"	Balance c/d	43,157				
			43,210				43,210

Branch Books

Head Office Account

2008			Rs.	2008			Rs.
Dec.31	To	Current Assets (Debtors)	750	Dec. 31	By	Balance b/d	22,645
					"	Goods in transit	3,641
	"	Balance c/d	28,036		"	Motor Vehicle	2,500
			28,786				28,786

Goods in Transit Account

2008		Rs.	2008		Rs.
Dec. 31	To Head Office	3,641	Dec. 31	By Balance c/d	3,641

Motor Vehicle Account

2008		Rs.	2008		Rs.
Dec. 31	To Head Office	2,500	Dec. 31	By Balance c/d	2,500

Sundry Current Assets A/c

2008		Rs.	2008		Rs.
Dec. 31	To Balance b/d	23,715	Dec. 31	By H.O. (Remittance by Debtor)	750
				" Balance c/d	22,965
		23,715			23,715

Balance Sheet of Major Ltd. as on 31st Dec., 2008

Liabilities	*Rs.*	*Assets*	*Rs.*
Share Capital		*Fixed Assets*	
Issued & Subscribed ....Shares of		Sundry Fixed Assets (cost less Depreciation)	96,526
Rs..... each fully paid	1,50,000	*Investments*	
Reserve & Surplus		*Current Assets*	
Revenue Reserve	-	*Loan & Advances*	
Secured Loans	53,407	Sundry Current Assets	1,51,169
Unsecured Loans	-		
Current Liabilities & Provisions			
Sundry Current Liabilities	44,288		
	2,47,695		2,47,695

Working Notes :

		Rs.
(*i*) Fixed Assets:	Head Office	75,125
	Branch	18,901
	Motor Vehicle	2,500
		96,526
(*ii*) Current Assets :	Head Office	1,21,809
	Cash in transit	3,500
	Branch (23,715–750)	22,965
	Stock in transit	3,641
		1,51,915
	Less : Stock Reserve	746
		1,51,169
(*iii*) Revenue Account :	Head Office (43,210 – 53)	43,157
	Branch	10,250
		53,407
(*iv*) Current Liabilities :	Head Office	34,567
	Branch	9,721
		44,288

(*v*) While incorporating branch profit, Head Office will credit its Profit & Loss A/c by Debiting Branch. This will increase the branch balance. Similarly branch will transfer net profit and loss to Head Office Account resulting in an increase in the balance of Head Office A/c by similar amount.

8. FOREIGN BRANCHES

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Thus problems of incorporating balances of foreign branches relate mainly to translation of foreign currency into Indian rupees. This is because exchange rate of Indian rupees is not stable in relation to foreign currencies due to international demand and supply effects on various currencies.

9. ACCOUNTING FOR FOREIGN BRANCHES

For the purpose of accounting, AS 11 (revised 2003) classifies the foreign branches may be classified into two types:

Integral Foreign Operation;

Non- Integral Foreign Operation.

Let us discuss these two types of foreign branches in detail.

9.1 Integral Foreign Operation (IFO): It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprise's operations. Generally, IFO carries on business in a single foreign currency, ie. of the country where it is located. For example, sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.

9.2 Non-Integral Foreign Operation (NFO): It is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency. An NFO may also enter into transactions in foreign currencies, including transactions in the reporting currency. An example of NFO may be production in a foreign currency out of the resources available in such country independent of the reporting enterprise.

The following are the indicators of Non- Integral Foreign Operation-

Control by reporting enterprises - While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on reporting enterprise.

Transactions with the reporting enterprises are not a high proportion of the foreign operation's activities.

Activities of foreign operation are mainly financed by its operations or from local borrowings. In other words it raises finance independently and is in no way dependent on reporting enterprises.

Foreign operation sales are mainly in currencies other than reporting currency.

All the expenses by foreign operations are primarily paid in local currency, not in the reporting currency.

Day-to-day cash flow of the reporting enterprises is independent of the foreign enterprises cash flows.

Sales prices of the foreign enterprises are not affected by the day-to-day changes in exchange rate of the reporting currency of the foreign operation.

There is an active sales market for the foreign operation product.

The above are only indicators and not decisive/conclusive factors to classify the foreign operations as non-integral, much will depend on factual information, situations of the particular case and, therefore, judgment is necessary to determine the appropriate classification.

Controversies may arise in deciding the foreign branches of the enterprises into integral or non-integral. However, there may not be any controversy that subsidiary associates and joint ventures are non-integral foreign operation.

In case of branches classified as independent for the purpose of accounting are generally classified as non-integral foreign operations.

10. CHANGE IN CLASSIFICATION

When there is a change in classification from –

Integral to non-integral

Non-integral to integral.

Accounting treatment is as under-

10.1 Integral To Non-Integral

(i) Translation procedure applicable to non-integral shall be followed from the date of change.

(ii) Exchange difference arising on the translation of non-monetary assets at the date of re-classification is accumulated in foreign currency translation reserve.

10.2 Non-Integral To Integral

(i) Translation procedure as applicable to integral should be applied from the date of change.

(ii) Translated amount of non-monetary items at the date of change is treated as historical cost.

(iii) Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation becomes integral.

11. TECHNIQUES FOR FOREIGN CURRENCY TRANSLATION

11.1 Integral Foreign Operation (IFO)

Following are the standard recommendations for foreign currency translation:

(1) All transactions of IFO be translated at the rate prevailing on the date of transaction. This will require date wise details of the transaction entered by that operation together with the

rates. Weekly or monthly average rate is permitted if there are no significant variations in the rate.

(2) Translation at the balance sheet date-

(i) Monetary items[1] at closing rate;

(ii) Non-monetary items[2]: The cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If tangible fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation.

(iii) The cost of inventories is translated a t the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

(iv) Exchange difference arising on the translation of the financial statement of integral foreign operation should be charged to profit and loss account.

11.2 Non-Integral Foreign Operation

Accounts of non-integral foreign operation are translated using the following principles:

Balance sheet items i.e. Assets and Liabilities both monetary and non-monetary – apply closing exchange rate.

Items of income and expenses – At actual exchange rates on the date of transactions. However, accounting standard allows average rate subject to materiality.

Resulting exchange rate difference should be accumulated in a "foreign currency translation reserve" until the disposal of "net investment in non-integral foreign operation".

Illustration 15

S & M Ltd., Bombay, have a branch in Sydney, Australia. Sydney branch is an integral foreign operation of S & M Ltd.

At the end of 31st March, 2008, the following ledger balances have been extracted from the books of the Bombay Office and the Sydney Office:

---

[1] Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Cash, receivables and payables are examples of monetary items.

[2] Non-monetary items are assets and liabilities other than monetary items. Fixed assets, investments in equity shares, inventories are examples of non-monetary assets.

	Bombay (Rs. thousands)		Sydney (Austr dollars thousands)	
	Debit	Credit	Debit	Credit
Share Capital	–	2,000	–	–
Reserves & Surplus	–	1,000	–	–
Land	500	–	–	–
Buildings (Cost)	1,000	–	–	–
Buildings Dep. Reserve	–	200	–	–
Plant & Machinery (Cost)	2,500	–	200	–
Plant & Machinery Dep. Reserve	–	600	–	130
Debtors / Creditors	280	200	60	30
Stock (1.4.2007)	100	–	20	–
Branch Stock Reserve	–	4	–	–
Cash & Bank Balances	10	–	10	–
Purchases / Sales	240	520	20	123
Goods sent to Branch	–	100	5	–
Managing Director's salary	30	–	–	–
Wages & Salaries	75	–	45	–
Rent	–	–	12	–
Office Expenses	25	–	18	–
Commission Receipts	–	256	–	100
Branch / H.O. Current A/c	120	–	–	7
	4,880	4,880	390	390

The following information is also available:

(1) Stock as at 31.3.2008:

Bombay Rs. 1,50,000

Sydney A $ 3,125

You are required to convert the Sydney Branch Trial Balance into rupees;

(use the following rates of exchange :

Opening rate	A $ = Rs. 20
Closing rate	A $ = Rs. 24
Average rate	A $ = Rs. 22
For Fixed Assets	A $ = Rs. 18).

Solution

Sydney Branch Trial Balance (in Rupees)

As on 31st March, 2008

(Rs. '000)

Conversion	rate per A$	*Dr.*	*Cr.*
Plant & Machinery (cost)	Rs. 18	36,00	
Plant & Machinery Dep. Reserve	Rs. 18		23,40
Debtors / Creditors	Rs. 24	14,40	7,20
Stock (1.4.2007)	Rs. 20	4,00	
Cash & Bank Balances	Rs. 24	2,40	
Purchase / Sales	Rs. 22	4,40	27,06
Goods received from H.O.	–	1,00	
Wages & Salaries	Rs. 22	9,90	
Rent	Rs. 22	2,64	
Office expenses	Rs. 22	3,96	
Commission Receipts	Rs. 22		22,00
H.O. Current A/c			1,20
		78,70	80,86
Exchange loss (balancing figure)		2,16	
		80,86	80,86

Illustration 16

Co. has head office at New York (U.S.A.) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of Carlin & Co.

Mumbai branch furnishes you with its trial balance as on 31st March, 2008 and the additional information given thereafter:

	Dr.	Cr.	
	Rupees in thousands		
Stock on 1st April, 2007	300	–	
Purchases and sales	800	1,200	
Sundry Debtors and creditors	400	300	
Bills of exchange	120	240	
Wages and salaries	560	–	
Rent, rates and taxes	360	–	
Sundry charges	160	–	
Computers		240	–
Bank balance	420	–	
New York office a/c	–	1,620	
	3,360	3,360	

Additional information:

(a) Computers were acquired from a remittance of US $ 6,000 received from New York head office and paid to the suppliers. Depreciate computers at 60% for the year.

(b) Unsold stock of Mumbai branch was worth Rs.4,20,000 on 31st March, 2008.

(c) The rates of exchange may be taken as follows:

on 1.4.2007 @ Rs. 40 per US $

on 31.3.2008 @ Rs. 42 per US $

average exchange rate for the year @ Rs. 41 per US $

conversion in $ shall be made upto two decimal accuracy.

You are asked to prepare in US dollars the revenue statement for the year ended 31st March, 2008 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York head office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $ 39609.18 on 31.3.2008 in New York books and there were no items pending reconciliation.

Solution

Carlin & Co. Ltd.

Mumbai Branch Trial Balance in (US $)

as on 31st March, 2008

	Conversion rate per US $ (Rs.)	*Dr. US $*	*Cr. US $*
Stock on 1.4.07	40	7,500.00	–
Purchases and sales	41	19,512.20	29,268.29
Sundry debtors and creditors	42	9,523.81	7,142.86
Bills of exchange	42	2,857.14	5,714.29
Wages and salaries	41	13,658.54	–
Rent, rates and taxes	41	8,780.49	–
Sundry charges	41	3,902.44	–
Computers	–	6,000.00	–
Bank balance	42	10,000.00	–
New York office A/c	–	–	39,609.18
		81,734.62	81,734.62

Trading and Profit & Loss Account

for the year ended 31st March, 2008

	US $		*US $*
To Opening Stock	7,500.00	By Sales	29,268.29
To Purchases	19,512.20	By Closing stock	10,000.00
To Wages and salaries	13,658.54	By Gross Loss c/d	1,402.45
	40,670.74		40,670.74
To Gross Loss b/d	1,402.45	By Net Loss	17,685.38
To Rent, rates and taxes	8,780.49		

To Sundry charges	3,902.44		
To Depreciation on computers	3,600.00		
(US $ 6,000 × 0.6)			
	17,685.38		17,685.38

Balance Sheet of Mumbai Branch

as on 31st March, 2008

Liabilities		*US $*	*Assets*	*US $*	*US $*
New York Office A/c	39,609.18		Computers	6,000.00	
Less : Net Loss	17,685.38	21,923.80	*Less* :Depreciation	3,600.00	2,400.00
Sundry creditors		7,142.86	Closing stock		10,000.00
Bills payable		5,714.29	Sundry debtors		9,523.81
			Bank balance		10,000.00
			Bills receivable		2,857.14
		34,780.95			34,780.95

Self-examination questions

I. Objective Type Questions

Choose the most appropriate answer from the given options:

1. Goods may be invoiced to branch at
   - (a) Cost.
   - (b) Selling price.
   - (c) Wholesale price.
   - (d) All of the above.
2. Under debtors method, opening balance of debtors is
   - (a) Debited to branch account.
   - (b) Credited to branch account.
   - (c) Debited to H.O account.
   - (d) Credited to H.O account.

3. Cost of goods returned by branch will have the following effect

   (a). Goods sent to branch account will be debited.

   (b). Goods sent to branch account will be debited.

   (c) Branch stock account will be credited.

   (d) (a) and (c).

4. Assets and liabilities of a non- integral foreign operation should be converted at

   (a) Closing rate.

   (b) Average rate.

   (c) Opening rate.

   (d) None of the above.

5. All of the following are examples of monetary assets except:

   (a) Cash.

   (b) Inventory.

   (c) Receivables.

   (d) Payables.

6. If asset is carried at cost, cost and depreciation of tangible fixed assets is translated at

   (a) Average rate.

   (b) Closing rate.

   (c) Opening rate.

   (d) Exchange rate at the date of purchase of asset.

7. Incomes and expenses of a NFO is translated at

   (a) Average rate that approximates the actual exchange rates.

   (b) Opening rate.

   (c) Exchange rate at the date of transaction.

   (d) Either (a) or (c)

8. AS 11 classifies foreign branches are classified as

   (a) Autonomous branches and non-autonomous branches

   (b) Uncontrolled and fully controlled branches.

   (c) Statutory and non-statutory branches.

   (d) Integral and non- integral foreign operation

{**Answer** : 1- (d), 2- (a), 3- (d), 4-(a), 5- (b), 6- (d), 7- (d), 8- (d)}

II. Short Answer Type Questions

9. Distinguish between integral and non- integral foreign operation.

10. What do you understand by the term 'Branch Adjustment account'?

11. Write short note on Dependent and independent branches.

III. Long Answer Type questions

12. (a) Explain the procedure for incorporation of branch balance in head office books.

    (b) How would you treat the changes in classification of foreign operation?

13. What is the purpose behind creating a reserve for the unsold stock in the branch, where stocks are sent by the head office at invoice price?

IV. Practical Problems

14. ABC Ltd. based in India has branches in London. The Vice-President (Accounts) is of the opinion that the net exchange difference of Rs.20 lakhs on the translation of items in financial statements of London Branches should be credited to the P &L Account of the Company and disclosed as follows –

Favourable exchange differences on items other than Fixed Assets	Rs.50 lakhs
Less: Unfavourable exchange difference on account of increase in	
Term liability on purchase of Fixed Asses	Rs.30 lakhs
Net Exchange Difference transferred to P & L account	Rs.20 lakhs

Do you agree with the Vice-President (Accounts)? Give reasons.

15. (*a*) A company charges out goods to its Bangalore Branch at cost. The branch remits daily to the H.O. all the cash collected by it on its sale; branch expenses are paid out of the amounts provided to the Branch by the H.O. as an imprest.

The following is the summary of transactions of the branch during the year ended Dec. 31.

	Rs.		Rs.
Stock Jan. at cost	10,000	Credit Sales	70,500
Stock Dec. 31 at cost	17,900	Cash received from debtors	61,000
Goods received from H.O.	1,00,000	Discount allowed to debtors	2,000
Debtors, Jan. 1	7,000	Allowance of selling price	
Debtors Dec. 31	14,000	(in invoice)	1,500
Cash Sales	40,000	Expenses at the Branch	8,000

Ascertain the profit earned by the Branch in three different methods.

(*b*) What difference would have been made to Branch profit in the above mentioned case if the goods were invoiced to the Branch at cost plus 25% instead of at cost?

16. The Head Office of the ABC Ltd. invoiced goods to its Northern Branch during the year at selling price 33.1/3% added to cost. During the year the cost of goods sent to the branch was Rs.65,400. The cash sales of the branch were Rs.31,000. The Branch returned stock valued at selling price Rs.2,000 to the head office and had Rs.1,000 returned to it by customers. The discount allowed to customers by the Branch amounted to Rs.200. The Branch remitted all the cash received by way of cash sales and receipts for customers. The opening and closing stock at the branch at invoice price were Rs.15,000 and Rs.36,000, respectively. The Branch had debtors of Rs.12,000 at the beginning and of Rs.9,200 at the end. loss (at invoice value) through pilferage was ascertained to be Rs.1,000.

    Write up the necessary accounts for recording the abovementioned transactions in the Head office books.

17. A head office had fixed retail price at cost plus 100%. It has a retail branch to which goods are invoiced at wholesale price which is 20% less than the list price. From the following particulars ascertain the profit earned by the branch.

	Rs.
Opening Stock (Invoice Price)	16,000
Goods sent to the Branch (cost to H.O.)	50,000
Sale at Branch	95,000

Ascertain the profit at the branch on wholesale price. What will be the Stock Reserve Account balance at the end of the year?

18. What are the distinguishing features between a Department and a branch? What advantages are derived from departmental accounts? How would the following expenses be apportioned between departments (*a*) Rent; (*b*) M.D.'s salary and commission; (*c*) Advertisement; (*d*) Insurance; (*e*) Income-tax; (*f*) Interest on borrowed capital?

19. Bombay Trading Co. Ltd., has a branch in Utopia which is an integral foreign operation. The currency of Utopia fluctuates in value. At the close of the accounting period the branch in Utopia sends its Trial Balance and financial statements of account made up in local currency. Describe the procedure to incorporate the branch figures in head office books. At what rate would you convert (*i*) Remittances from Utopia, (*ii*) Current Assets, (*iii*) Goodwill, (*iv*) Depreciation of furniture, (*v*) Bad Debts, (*vi*) Provision for Doubtful Debts?

20. The Head Office of a company invoices goods to its branch at cost plus a loading of 33.1/3%. At the end of the accounting period it is found that actual stock in hand at invoice price had fallen short of the balance by Rs.1,000. This difference is due to the following factors:

    Goods destroyed by fire at invoice price Rs.1,000.

    Goods of the invoice value of Rs.1,000 having been stolen.

    Cash stolen from the branch till amounting to Rs.2,000.

    Allowances from selling price granted to customers to Rs.2,400.

    Normal wastage of stock during the period amounting to Rs.4,000.

    Set up the adjusting entries in books of the Head Office.

21. A London firm has a branch (integral foreign operation) at Calcutta and following is the summary of balances appearing in Calcutta books at the first year as at 30th June, 2008. London Account Rs.3,16,080. Purchase Rs.3,43,106. Wages and Salaries Rs.62,416, Sales Rs.4,63,413. Interest credit Rs.7,616. Freight Rs.35,004. Creditors Rs. 75,108, Debtors Rs.16,512, Bank Rs.63,094, General charges Rs.32,116, Investments Rs.1,38,928, Cash Rs.2,012, Loan Rs.30,000.

    Rates of Exchange:

    1st June, 2007 Rs.40 to £1

    30 June, 2008 Rs.38 to £1

Average Rate Rs.39 to £1

On the date of purchase of furniture Rs.23 to £1

You are required to give the branch's converted Trial Balance. The branch balance in the Head Office Books appears at £15,804.

22. Evergreen & Co., Calcutta, has branches at Murshidabad and Hooghly. The Head Office makes purchases and sends goods to Branches at cost plus 75 per cent. Branches remit their collection to H.O. after meeting their expenses. Following are the further details for the year ended 31-3-2008.

	Murshidabad	*Hooghly*
	Rs.	*Rs.*
Opening Balance 1-4-2007		
Stock (Invoice price)	30,000	40,000
Debtors	56,000	62,000
Cash on hand	7,200	10,300
Furniture & fittings	7,200	8,500
Goods sent to branch (Invoice price)	3,60,000	4,20,000
Goods returned by the Branch		
(Invoice price)	3,600	-
Sales: Cash Sales	1,12,000	1,32,500
Credit Sales	2,45,000	2,95,000
Collection from debtors	2,60,000	2,97,000
Remittance to H.O.	3,55,000	4,20,000
Closing Balance:		
Stock (Invoice price)	30,400	35,000
Cash on hand	12,000	4,500

Provide depreciation @ 10% on furniture/fittings.

Prepare Branch A/c as it would appear in H.O. books under (*i*) Debtors Method, (*ii*) Stock and Debtors Method, and (*iii*) Memorandum Trading and Profit & Loss A/c Method.

23. An Indian company has a branch at Washington. Washington branch is a non-integral foreign operation of the Indian Company.

The Trial Balance of Washington branch as at 30th September, 2008 is as follows:

	Dr. US $	Cr. US $
Plant and machinery	1,20,000	–
Furniture and fixtures	8,000	–
Stock, Oct. 1, 2007	56,000	–
Purchases	2,40,000	–
Sales	–	4,16,000
Goods from Indian Co. (H.O.)	80,000	–
Wages	2,000	–
Carriage inward	1,000	–
Salaries	6,000	–
Rent, rates and taxes	2,000	–
Insurance	1,000	–
Trade expenses	1,000	–
Head Office A/c	–	1,14,000
Trade debtors	24,000	–
Trade creditors	–	17,000
Cash at bank	5,000	–
Cash in hand	1,000	–
	5,47,000	5,47,000

The following further information is given :

Wages outstanding – $ 1,000.

Depreciate Plant and Machinery and Furniture and Fixtures @ 10 % p.a on WDV basis..

The Head Office sent goods to Branch for Rs. 39,40,000.

The Head Office shows an amount of Rs. 43,00,000 due from Branch.

Stock on 30th September, 2008 – $ 52,000.

There were no in transit items either at the start or at the end of the year.

On September 1, 2006, when the fixed assets were purchased, the rate of exchange was Rs. 38 to one $.

On October 1, 2007, the rate was Rs. 39 to one $.

On September 30, 2008, the rate was Rs. 41 to one $.

Average rate during the year was Rs. 40 to one $.

You are asked to prepare:

(a) Trial balance incorporating adjustments given under 1 to 4 above, converting dollars into rupees.

(b) Trading and Profit and Loss Account for the year ended 30th September, 2008 and Balance Sheet as on that date depicting the profitability and net position of the Branch as would appear in India for the purpose of incorporating in the main Balance Sheet.

APPENDIX I

CONCEPTUAL FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

The following is the text of the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India.

INTRODUCTION

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Frameworks is to :

(*a*) assist prepares of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(*b*) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

(*c*) assist the Accounting Standards Board in promoting harmonisation of regulations, accounting standards and procedures relating to the preparation and presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by Accounting Standards;

(*d*) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(*e*) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(*f*) provide those who are interested in the work of the Accounting Standards Board with information about its approach to the formulation of Accounting Standards.

2. This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.

3. The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.

4. The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

Scope

5. The Framework deals with :

(*a*) the objective of financial statements;

(*b*) the qualitative characteristics that determine the usefulness of information provided in financial statements;

(*c*) definition, recognition and measurement of the elements from which financial statements are constructed; and

(*d*) concepts of capital and capital maintenance.

6. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

7. 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.

8. The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

9. 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 fo 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 continunance 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.

10. While all the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investoers need more comprehensive information than other users. The provision of financial

statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework. **THE OBJECTIVE OF FINANCIAL STATEMENTS**

12. 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.

13. 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.

14. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainity of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay laons, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in

predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

18. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

20. The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

UNDERLYING ASSUMPTIONS

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they

relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used in disclosed.

Consistency

24. In order to achieve comparability of the financial statements of an enterprise through time, the accounting policieis are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

QUALITATIVE CHARACTERISTICS OF FINANCIAL STATEMENTS

25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

26. An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevence to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

28. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and

its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

29. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicity forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statements of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

30. The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the items or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recgonise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. 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.

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

37. The preparers of financial statements have to contend with the uncertainties that inevitably surround many events and cirumstances, 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 or reliability. Completeness

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different entereprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a

balance between relevance and reliability, the overriding consideration is how best to satisfy the information need of users.

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefit derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgemental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement.

True and Fair View

46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

Elements of financial statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expeneses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

48. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Postion

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows :

(a) An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

(b) 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.

(c) Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 82 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalent to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

53. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be :

(*a*) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;

(*b*) exchanged for other assets;

(*c*) used to settle a liability; or

(*d*) distributed to the owners of the enterprise.

55. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obatined from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

57. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

59. An essential characteristic of a liability its that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be

legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods an services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrecoverable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

61. The settlements of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by :

(*a*) payment of cash;

(*b*) transfer of other assets;

(*c*) provision of services;

(*d*) replacement of that obligation with another obligation; or

(*e*) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights. 62. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

64. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, funds contributed by owners, reserves representing

appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustements may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

65. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves in information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

66. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

67. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike, corporate enterprises in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

68. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. The concepts are discussed in paragraphs 101 to 109.

69. Income and expenses are defined as follows :

(*a*) Income is increase 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.

(*b*) Expenses are decreased in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

70. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recgonised in the statement of profit and loss. Criteria for recognition of income and expenses are discussed in paragraphs 81 to 97.

71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

72. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusivenees. For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

73. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalities and rent.

74. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

75. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

76. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

78. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

79. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recgonised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

80. The revaluation or restatement of assets and liabilities give rise to increases or decreases in equity. While these increases or decreases to meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 101 to 109 of this Framework.

RECOGNITION OF THE ELEMENTS OF FINANCIAL STATEMENTS

81. Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisifies the criteria for recognition set out in paragraph 82. It involves the depiction of the items in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recgonition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

82. An item that meets the definition of an element should be recognised if :

(*a*) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(*b*) the items has a cost or value that can be measured with reliability.

83. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraph 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterizes the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

85. The second criterion for the recognition of an item is that it possesses a cost of value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

86. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 82 may qualify for recognition at a later date as a result of subsequent circumstances or events.

87. An item that possess the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an

enterprise by the users of financial statements. Thus, in the example given in paragraph 85, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

90. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decreaase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

93. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

94. Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneously or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recgonise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

97. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

MEASUREMENT OF THE ELEMENTS OF FINANCIAL STATEMENTS

98. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

99. A number of different measurement bases are employed to different degrees and in varying combination in financial statements. They include the following :

(*a*) Historical cost. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(*b*) Current cost. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(*c*) Realisable (settlement) value. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is , the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(*d*) Present value. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

100. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of capital and capital maintenance

101. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

102. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the mainconcern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

103. The concepts of capital described in paragraph 101 give rise to the following concepts of capital maintenance :

(*a*) Financial capital maintenance. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(*b*) Physical capital maintenance. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

104. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return on capittal and its return of capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

105. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

106. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

107. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase

in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

108. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

109. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

APPENDIX II

AS 4 (REVISED) : CONTINGENCIES AND EVENTS OCCURRING AFTER THE BALANCE SHEET DATE

The following is the text of the revised Accounting Standard (AS) 4, 'Contingencies and Events Occurring after the Balance Sheet Date' issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1995 and is mandatory in nature.[1] It is clarified that in respect of accounting periods commencing on a date prior to 1-4-1995, Accounting Standard 4 as originally issued in November, 1982 (and subsequently made mandatory) applies.

Introduction

1. This Statement deals with the treatment in financial statements of

(a) contingencies, and

(b) events occurring after the balance sheet date.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Statement in view of special considerations applicable to them :

(a) liabilities of life assurance and general insurance enterprises arising from policies issued;

(b) obligations under retirement benefit plans; and

(c) commitments arising from long-term lease contracts.

Definitions

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

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[1] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1.4.2004, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards

3.1 A *contingency*[2] is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

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

Two types of events can be identified :

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

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

Explanation

4. **Contingencies**

4.1 The term “contingencies” used in this Statement is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

4.2 Estimates are required for determining the amount to be stated in the financial statements for many ongoing and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation, does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

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[2] See footnote 1.

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

5. *Accounting Treatment of Contingent Losses*

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. *Determination of the Amounts at which Contingencies are included in Financial Statements*

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

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

8. **Events Occurring after the Balance Sheet Date**

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (*e.g.,* destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. **Disclosure**

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Accounting Standard

(*The Accounting Standard comprises paragraphs 10-17 of this Statement. The Standard should be read in the context of paragraphs 1-9 of this Statement and of the 'Preface to the Statements of Accounting Standards'.)*

Contingencies

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

(a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and

(b) a reasonable estimate of the amount of the resulting loss can be made.

11. The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote.

12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

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

14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

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

(a) the nature of the contingency;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect, or a statement that such an estimate cannot be made.

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

(*a*) ***the nature of the event;***

(*b*) ***an estimate of the financial effect, or a statement that such an estimate cannot be made.***

AS 5 (REVISED) NET PROFIT OR LOSS FOR THE PERIOD, PRIOR PERIOD ITEMS AND CHANGES IN ACCOUNTING POLICIES*

The following is the text of the revised Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies, issued by the Council of the Institute of Chartered Accountants of India.

This revised standard comes into effect in respect of accounting periods commencing on or after 1-4-1996, and is mandatory in nature. It is clarified that in respect of accounting periods commencing on a date prior to 1-4-1996, Accounting Standard (AS) 5 as originally issued in November, 1982 (and subsequently made mandatory), will apply.

Objective

The objective of this Statement is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Statement requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items, within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope

1. ***This Statement should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.***

2. This Statement deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

3. This Statement does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

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

Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

Accounting policies are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

5. All items of income and expenses which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss :

(a) Profit or loss from ordinary activities; and

(b) Extraordinary items.

Extraordinary Items

8. Extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived.

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policy-holders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are :—

- attachment of property of the enterprise; or
- an earthquake.

Profit or Loss from Ordinary Activities

12. When items of income and expense within profit or 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.

13. Although the items of income and expense described in Paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with Paragraph 12 include :

(a) the write-down of inventories to net realisable value as well as the reversal of such write-downs;

(b) a restructuring of the activities of an enterprise and the reversal of any provisions for the costs of restructuring;

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Prior Period Items

15. The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on the current profit or loss can be perceived.

16. The term 'prior period items', as defined in this Statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period *e.g.,* arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence, or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience, or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in :

(a) the period of the change; if the change affects the period only; or

(b) the period of the change and future periods, if the change affects both.

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

25. The effect of a change in an accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate.

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

27. The nature and amount of a change in an accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed.

Changes in Accounting Policies

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order not identify trends in its financial position, performance, and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance, or cash flows of the enterprise.

31. The following are not changes in accounting policies :

(a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions *e.g.,* introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

"33. A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32 of this Statement should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard. "

The Council of the Institute of Chartered Accountants of India decided to add this paragraph after paragraph 32 of AS 5.

The above revision comes into effect in respect of accounting periods commencing on or after 1.4.2001.

AS 11 (Revised 2003): THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES

*(In this Accounting Standard, the standard portions have been set in **bold italic** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'[3].)*

Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates (revised 2003), issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature[4] from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

The following is the text of the revised Accounting Standard.

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Statement should be applied:

(a) in accounting for transactions in foreign currencies; and

(b) in translating the financial statements of foreign operations.

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[1]Attention is specifically drawn to paragraph 4.3 of the Preface, according to which accounting standards are intended to apply only to material items.

[4] This implies that, while discharging their attest function, it will be the duty of the members of the Institute to examine whether this Accounting Standard is complied with in the presentation of financial statements covered by their audit. In the event of any deviation from this Accounting Standard, it will be their duty to make adequate disclosures in their audit reports so that the users of financial statements may be aware of such deviations.

2. This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.
3. This Statement does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Statement requires disclosure of the reason for using that currency. This Statement also requires disclosure of the reason for any change in the reporting currency.
4. This Statement does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.
5. This Statement does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).
6. This Statement does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

Definitions

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

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

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

***Exchange difference** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.*

***Exchange rate** is the ratio for exchange of two currencies.*

It may be noted that on the basis of a decision of the Council at its meeting held on June 24-26, 2004, an Announcement title "Applicability of Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates, in respect of exchange differences arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction' has been issued. The Announcement clarifies that AS 11 (revised 2003) does not deal with the accounting of exchange difference arising on a forward exchange contract entered into to hedge the foreign currency risk of a firm commitment or a highly probable forecast transaction. It has also been separately clarified that AS 11 (revised 2003) continues to be applicable to exchange differences on all other forward exchange contracts.

***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.*

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

***Foreign operation** is a subsidiary[3], associate[4], joint venture[5] or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.*

***Forward exchange contract** means an agreement to exchange different currencies at a forward rate.*

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

***Integral foreign operation** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.*

***Monetary items** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.*

***Net investment in a non-integral foreign operation** is the reporting enterprise's share in the net assets of that operation.*

***Non-integral foreign operation** is a foreign operation that is not an integral foreign operation.*

***Non-monetary items** are assets and liabilities other than monetary items.*

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

Foreign Currency Transactions

Initial Recognition

8. A foreign currency transaction is a transaction which is denominated in or requires settlement in a foreign currency, including transactions arising when an enterprise either:

   (a) buys or sells goods or services whose price is denominated in a foreign currency;

   (b) borrows or lends funds when the amounts payable or receivable are denominated in a foreign currency;

[3] As defined in AS 21, Consolidated Financial Statements.

[4] As defined in AS 23, Accounting for Investments in Associates in Consolidated Financial Statements.

[5] As defined in AS 27, Financial Reporting of Interests in Joint Ventures.

(c) becomes a party to an unperformed forward exchange contract; or

(d) otherwise acquires or disposes of assets, or incurs or settles liabilities, denominated in a foreign currency.

9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

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

(b) non-monetary items which are carried in terms of historical cost denominated in a foreign currency should be reported using the exchange rate at the date of the transaction; and

(c) non-monetary items which are carried at fair value or other similar valuation denominated in a foreign currency should be reported using the exchange rates that existed when the values were determined.

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency

items are then reported in the reporting currency in accordance with this Statement. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences[£]

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.

14. An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction. When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period. However, when the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

[£] It may be noted that the Institute has issued in 2003 an Announcement titled 'Treatment of exchange differences under Accounting Standard (AS) 11 (revised 2003), The Effects of Changes in Foreign Exchange Rates vis-à-vis Schedule VI to the Companies Act, 1956'. As per the Announcement, the requirement with regard to treatment of exchange differences contained in AS 11 (revised 2003), is different from Schedule VI to the Companies Act, 1956, since AS 11 (revised 2003) does not require the adjustment of exchange differences in the carrying amount of the fixed assets, in the situations envisaged in Schedule VI. It has been clarified that pending the amendment, if any, to Schedule VI to the Companies Act, 1956, in respect of the matter, a company adopting the treatment described in Schedule VI will still be considered to be complying with AS 11(revised 2003) for the purpose of section 211 of the act.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

20. The following are indications that a foreign operation is a non-integral foreign operation rather than an integral foreign operation:

    (a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

(c) the activities of the foreign operation are financed mainly from its own operations or local borrowings rather than from the reporting enterprise;

(d) costs of labour, material and other components of the foreign operation's products or services are primarily paid or settled in the local currency rather than in the reporting currency;

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

(g) sales prices for the foreign operation's products are not primarily responsive on a short-term basis to changes in exchange rates but are determined more by local competition or local government regulation; and

(h) there is an active local sales market for the foreign operation's products, although there also might be significant amounts of exports.

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non-integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Integral Foreign Operations

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net

realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.

23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

24. In translating the financial statements of a non-integral foreign operation for incorporation in its financial statements, the reporting enterprise should use the following procedures:

(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;

(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and

(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.

25. For practical reasons, a rate that approximates the actual exchange rates, for example an average rate for the period, is often used to translate income and expense items of a foreign operation.

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

(a) translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;

(b) translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and

(c) other changes to equity in the non-integral foreign operation.

These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a non-integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non-integral foreign operation is translated at the closing rate in accordance with paragraph 24.

28. A contingent liability disclosed in the financial statements of a non-integral foreign operation is translated at the closing rate for its disclosure in the financial statements of the reporting enterprise.

29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra-group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in

accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

32. An enterprise may dispose of its interest in a non-integral foreign operation through sale, liquidation, repayment of share capital, or abandonment of all, or part of, that operation. The payment of a dividend forms part of a disposal only when it constitutes a return of the investment. In the case of a partial disposal, only the proportionate share of the related accumulated exchange differences is included in the gain or loss. A write-down of the carrying amount of a non-integral foreign operation does not constitute a partial disposal. Accordingly, no part of the deferred foreign exchange gain or loss is recognised at the time of a write-down.

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts

36. An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction. The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract. Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change. Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss

for the period. The premium or discount on the forward exchange contract is not recognised separately.

39. In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Disclosure

40. An enterprise should disclose:

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

(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

41. When the reporting currency is different from the currency of the country in which the enterprise is domiciled, the reason for using a different currency should be disclosed. The reason for any change in the reporting currency should also be disclosed.

42. When there is a change in the classification of a significant foreign operation, an enterprise should disclose:

(a) the nature of the change in classification;

(b) the reason for the change;

(c) the impact of the change in classification on shareholders' funds; and

(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.

43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Transitional Provisions

45. On the first time application of this Statement, if a foreign branch is classified as a non-integral foreign operation in accordance with the requirements of this Statement, the accounting treatment prescribed in paragraphs 33 and 34 of the Statement in respect of change in the classification of a foreign operation should be applied.

Appendix

Note: This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 11 (revised 2003) and corresponding International Accounting Standard (IAS) 21 (revised 1993).

Comparison with IAS 21, The Effects of Changes in Foreign Exchange Rates (revised 1993)

Revised AS 11 (2003) differs from International Accounting Standard (IAS) 21, The Effects of Changes in Foreign Exchange Rates, in the following major respects in terms of scope, accounting treatment, and terminology.

1. Scope

Inclusion of forward exchange contracts

Revised AS 11 (2003) deals with forward exchange contracts both intended for hedging and for trading or speculation. IAS 21 does not deal with hedge accounting for foreign currency items other than the classification of exchange differences arising on a foreign currency liability accounted for as a hedge of a net investment in a foreign entity. It also does not deal with forward exchange contracts for trading or speculation. The aforesaid aspects are dealt with in IAS 39, Financial Instruments: Recognition and Measurement. Although, an Indian accounting standard corresponding to IAS 39 is under preparation, it has been decided to deal with accounting for forward exchange contracts in the revised AS 11 (2003), since the existing AS 11 deals with the same. Thus, accounting for forward exchange contracts would not remain unaddressed untill the issuance of the Indian accounting standard on financial instruments.

2. Accounting treatment

Recognition of exchange differences resulting from severe currency devaluations

IAS 21, as a benchmark treatment, requires, in general, that exchange differences on transactions be recognised as income or as expenses in the period in which they arise. IAS 21, however, also permits as an allowed alternative treatment, that exchange differences that arise from a severe devaluation or depreciation of a currency be included in the carrying amount of an asset, if certain conditions are satisfied. In line with the preference of the Council of the Institute of Chartered

Accountants of India, to eliminate alternatives, where possible, revised AS 11 (2003) adopts the benchmark treatment as the only acceptable treatment.

3. Terminology

Foreign operation

The revised AS 11 (2003) uses the terms, *integral foreign operation* and *non-integral foreign operation* respectively for the expressions "foreign operations that are integral to the operations of the reporting enterprise" and "foreign entity" used in IAS 21. The intention is to communicate the meaning of these terms concisely. This change has no effect on the requirements in revised AS 11 (2003). Revised AS 11 (2003) provides additional implementation guidance by including two more indicators for the classification of a foreign operation as a non-integral foreign operation.

AS 12 : ACCOUNTING FOR GOVERNMENT GRANTS

The following is the text of the Accounting Standard (AS) 12 issued by the Council of the Institute of Chartered Accountants of India on 'Accounting for Government Grants'.

The Standard comes into effect in respect of accounting periods commencing on or after 1-4-1992 and will be recommendatory in nature for an initial period of two years. Accordingly, the Guidance Note on 'Accounting for Capital Based Grants' issued by the Institute in 1981 shall stand withdrawn from this date. This Standard will become mandatory in respect of accounts for periods commencing on or after 1-4-1994.[1]

Introduction

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

2. This Statement does not deal with :

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

   (ii) Government assistance other than in the form of government grants ; and

   (iii) Government participation in the ownership of the enterprise.

Definitions

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

3.1 *Government* refers to government, government agencies and similar bodies whether local, national or international.

3.2 *Government grants* are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

4. The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefore is necessary. Secondly, it is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the reporting period.

This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

5. *Capital Approach versus Income Approach*

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

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

(i) Many government grants are in the nature of promoters' contribution, *i.e.,* they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

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

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

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

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

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

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

5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption [*see* Accounting Standard (AS) 1, Disclosure of Accounting policies*).*

5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

6. Recognition of Government Grants

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

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them ; and

(ii) where such benefits have been earned by the enterprise and it is reasonably certain that the ultimate collection will be made.

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

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

6.3 A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[5]

6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate [*see* Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][6].

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[5] Pursuant to AS 29, becoming mandatory in respect of accounting periods commencing on or afer 1.4.2004, all paragraphs of As 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standard.

[6] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

6.5 Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate [*see* Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting policies].

7. Non-monetary Government Grants

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

8. Presentation of Grants Related to Specific Fixed Assets

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

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

8.4 Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after ‘Reserves and Surplus’ but before ‘Secured Loans’ with a suitable description, *e.g.,* ‘Deferred government grants’.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

9. Presentation of Grants Related to Revenue

9.1 Grants related to revenue are sometimes presented as a credit in the profit and loss statement, either separately or under a general heading such as 'Other Income'. Alternatively, they are deducted in reporting the related expense.

9.2 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

10. Presentation of Grants of the Nature of Promoters' Contribution

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

11. Refund of government grants

11.1 Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item [see Accounting Standard (AS) 5, Prior Period Extraordinary Items and Changes in Accounting Policies][1].

11.2 The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.

11.3 The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, *i.e.,* where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

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[1] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

11.4 Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfilment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

12. Disclosure

12.1 The following disclosures are appropriate :

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

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

Accounting Standard

(*The Accounting Standard comprises paragraphs 13 to 23 of this Statement. The Standard should be read in the context of paragraphs 1 to 12 of this Statement and of the 'Preface to the Statements of Accounting Standards'.*)

13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

17. Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

18. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related cost, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if appropriate [see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][2].

19. A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

20. Government grants that become refundable should be accounted for as an extraordinary item [see Accounting Standard (AS) 5, Prior Period and Extraordinary Items and Changes in Accounting Policies][3].

21. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

22. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

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[2] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

[3] AS 5 has been revised in February, 1997. The title of revised AS 5 is 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies'.

Disclosure

23. The following should be disclosed :

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

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

AS 16 : BORROWING COSTS

(In this Accounting Standard, the standard portions have been set in ***bold italic*** *type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards').*

The following is the text of Accounting Standard (AS) 16, 'Borrowing Costs', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature. Paragraph 9.2 and paragraph 20 (except the first sentence) of Accounting Standard (AS) 10, 'Accounting for Fixed Assets', stand withdrawn from this date.

OBJECTIVE

The objective of this Statement is to prescribe the accounting treatment for borrowing costs.

SCOPE

1. ***This statement should be applied in accounting for borrowing costs.***

2. This Statement does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

DEFINITIONS

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

Borrowing costs are interest and other costs incurred by an enterprise in connection with the borrowing of funds.

A qualifying asset is an asset that necessarily takes a substantial period of time[1] to get ready for its intended use or sale.

4. Borrowing costs may include:

[1] See also Accounting Standards Interpretation (ASI)1.

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

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

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

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

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

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

RECOGNITION

6. ***Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are incurred.***

7. Borrowing costs are capitalised as part of the cost of a qualifying asset when it is probable that they will result in future economic benefits to the enterprise and the costs can be measured reliably. Other borrowing costs are recognised as an expense in the period in which they are incurred.

Borrowing Costs Eligible for Capitalisation

8. The borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset are those borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made. when an enterprise borrows funds

See also Accounting Standards Interpretation (ASI)1.

specifically for the purpose of obtaining a particular qualifying asset, the borrowing costs that directly relate to that qualifying asset can be readily identified.

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

10. ***To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.***

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

12. ***To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.***

EXCESS OF THE CARRYING AMOUNT OF THE QUALIFYING ASSET OVER RECOVERABLE AMOUNT

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

COMMENCEMENT OF CAPITALISATION

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

- ***(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;***
- ***(b) borrowing costs are being incurred; and***
- ***(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.***

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

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

SUSPENSION OF CAPITALISATION

17***. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.***

18. Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example, capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

CESSATION OF CAPITALISATION

19. ***Capitalisation of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.***

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

21. ***When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete.***

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

DISCLOSURE

23. ***The financial statements should disclose:***

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

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

AS 19 : LEASES

*(In this Accounting Standard, the standard portions have been set in **bold italic** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'.)*

AS 19, 'Leases', issued by the Council of the Institute of Chartered Accountants of India. This Standard comes into effect in respect of all assets leased during accounting periods commencing on or after 1.4.2001 and is mandatory in nature from that date. Accordingly, the 'Guidance Note on Accounting for Leases' issued by the Institute in 1995, is not applicable in respect of such assets. Earlier application of this Standard is, however, encouraged.

In respect of accounting periods commencing on or after 1-4-2004, an enterprise which does not fall in any of the following categories need not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard:

(i) Enterprises whose equity or debt securities are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs.50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs.10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

In respect of an enterprise which falls in any one or more of the above categories, at any time during the accounting period, the Standard is applicable in its entirety.

Where an enterprise has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e), of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable, in its entirety, from the current period. However, the corresponding previous period figures in respect of above paragraphs need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraphs 22(c), (e) and (f); 25(a), (b) and (e); 37(a), (f) and (g); and 46(b), (d) and (e) should disclose the fact.

The following is the text of the Accounting Standard. [7]

OBJECTIVE

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

SCOPE

1. This Statement should be applied in accounting for all leases other than:

- ***(a) lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and***
- ***(b) licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights; and***
- ***(c) lease agreements to use lands.***

2. This Statement applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Statement does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

DEFINITIONS

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

A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

An operating lease is a lease other than a finance lease.

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[7] AS 19 was originally made mandatory in its entirety, for all enterprises in respect of all assets leased during accounting periods commencing on or after 1.4.2001.

A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(b) in the case of the lessor, any residual value guaranteed to the lessor:

(i) by or on behalf of the lessee; or

(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

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.

Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

***Useful life** of a leased asset is either:*

(a) the period over which the leased asset is expected to be used by the lessee; or

(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

***Residual value** of a leased asset is the estimated fair value of the asset at the end of the lease term.*

***Guaranteed residual value** is :*

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

***Unguaranteed residual value** of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.*

***Gross investment in the lease** is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.*

***Unearned finance income** is the difference between:*

(a) the gross investment in the lease; and

(b) the present value of

(i) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

***Net investment in the lease** is the gross investment in the lease less unearned finance income.*

*The **interest rate implicit in the lease** is the discount rate that, at the inception of the lease, causes the aggregate present value of*

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

4. 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. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

CLASSIFICATION OF LEASES

5. The classification of leases adopted in this Statement is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

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

7. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the differing circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

(b) the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

(e) the leased asset is of a specialised nature such that only the lessee can use it without major modifications being made.

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example, in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent.

10. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 5 to 9 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

LEASES IN THE FINANCIAL STATEMENTS OF LESSEES

Finance Leases

11. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example

(a) An enterprise (the lessee) acquires a machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery, i.e. 3 years. The fair value of the machinery on January 1, 20X0 is Rs.2,35,500. The lease agreement requires the lessee to pay an amount of Rs.1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of Rs.17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only Rs.3,500 on December 31, 20X2. The interest rate implicit in the lease is 16 per cent (approx.). This is calculated using the following formula:

$$\text{Fair value} = \frac{ALR}{(1+r)^1} + \frac{ALR}{(1+r)^2} + \ldots\ldots\ldots\ldots + \frac{ALR}{(1+r)^n} + \frac{RV}{(1+r)^n}$$

where ALR is annual lease rental,

RV is residual value (both guaranteed and unguaranteed),

n is the lease term,

r is interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is Rs.2,35,500.

The lessee would record the machinery as an asset at Rs.2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of Rs.17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of Rs.5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at 16% (approx.). The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be Rs.2,27,805. As this amount is lower than the fair value of the leased asset (Rs. 2,35,500), the lessee would recognise the asset and the liability arising from the lease at Rs.2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be computed using the lessee's incremental borrowing rate.

12. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic

benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

13. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

14. It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

15. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

16. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example

In the example (a) illustrating paragraph 11, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows.

	Year	Finance charge (Rs.)	Payment (Rs.)	Reduction in outstanding liability (Rs.)	Outstanding liability (Rs.)
Year 1	(January 1)				2,35,500
	(December 31)	37,680	1,00,000	62,320	1,73,180
Year 2	(December 31)	27,709	1,00,000	72,291	1,00,889

Year 3	(December 31)	16,142	1,00,000	83,858	17,031

17. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

18. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

19. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

20. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

21. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[1], that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

22. The lessee should, in addition to the requirements of AS 10, Accounting for Fixed Assets, AS 6, Depreciation Accounting, and the governing statute, make the following disclosures for finance leases:

(a) assets acquired under finance lease as segregated from the assets owned;

The difference between this figure and guaranteed residual value (Rs. 17,000) is due to approximation in computing the interest rate implicit in the lease.

[1] AS 28, 'impairment of Assets', specifies the requirements relating to impairment of assets.

(b) *for each class of assets, the net carrying amount at the balance sheet date;*

(c) *a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:*

  (i) *not later than one year;*

  (ii) *later than one year and not later than five years;*

  (iii) *later than five years;*

(d) *contingent rents recognised as income in the statement of profit and loss for the period;*

(e) *the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and*

(f) *a general description of the lessee's significant leasing arrangements including, but not limited to, the following:*

  (i) *the basis on which contingent rent payments are determined;*

  (ii) *the existence and terms of renewal or purchase options and escalation clauses; and*

  (iii) *restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.*

OPERATING LEASES

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

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

25. The lessee should make the following disclosures for operating leases:

(a) *the total of future minimum lease payments under non-cancellable operating leases for each of the following periods:*

  (i) *not later than one year;*

  (ii) *later than one year and not later than five years;*

(iii) later than five years;

(b)** **the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date;

(c) lease payments recognised in the statement of profit and loss for the period, with separate amounts for minimum lease payments and contingent rents;

(d) sub-lease payments received (or receivable) recognised in the statement of profit and loss for the period;

(e) a general description of the lessee's significant leasing arrangements including, but not limited to, the following:

(i) the basis on which contingent rent payments are determined;

(ii) the existence and terms of renewal or purchase options and escalation clauses; and

(iii) restrictions imposed by lease arrangements, such as those concerning dividends, additional debt, and further leasing.

LEASES IN THE FINANCIAL STATEMENTS OF LESSORS

Finance Leases

26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

27. Under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services.

28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

29. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.

30. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any

reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

31. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

32. The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

33. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

34. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. The lessor should make the following disclosures for finance leases:

(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

(b) unearned finance income;

(c) the unguaranteed residual values accruing to the benefit of the lessor;

(d) the accumulated provision for uncollectible minimum lease payments receivable;

(e) contingent rents recognised in the statement of profit and loss for the period;

(f) a general description of the significant leasing arrangements of the lessor; and

(g) accounting policy adopted in respect of initial direct costs.

38. As an indicator of growth it is often useful to also disclose the gross investment less unearned income in new business added during the accounting period, after deducting the relevant amounts for cancelled leases.

OPERATING LEASES

39. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

40. Lease income from operating leases should be recognised in the statement of profit and loss on a straight line basis over the lease term, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

42. Initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rent income, or are recognised as an expense in the statement of profit and loss in the period in which they are incurred.

43. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

44. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[2] that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

45. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

46. The lessor should, in addition to the requirements of AS 6, Depreciation Accounting and AS 10, Accounting for Fixed Assets, and the governing statute, make the following disclosures for operating leases:

- ***(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and***
  - ***(i) the depreciation recognised in the statement of profit and loss for the period;***
  - ***(ii) impairment losses recognised in the statement of profit and loss for the period;***
  - ***(iii) impairment losses reversed in the statement of profit and loss for the period;***
- ***(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:***
  - ***(i) not later than one year;***
  - ***(ii) later than one year and not later than five years;***
  - ***(iii) later than five years;***
- ***(c) total contingent rents recognised as income in the statement of profit and loss for the period;***
- ***(d) a general description of the lessor's significant leasing arrangements; and***

[2] AS 28, 'impairment of Assets', specifies the requirements relating to impairment of assets.

(e) accounting policy adopted in respect of initial direct costs.

SALE AND LEASEBACK TRANSACTIONS

47. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

49. If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

51. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

53. For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to

disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

APPENDIX

Sale and Leaseback Transactions that Result in Operating Leases

The appendix is illustrative only and does not form part of the accounting standard. The purpose of this appendix is to illustrate the application of the accounting standard.

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The following table shows the requirements of the accounting standard in various circumstances.

Sale price established at fair value (paragraph 50)	**Carrying amount equal tofair value**	**Carrying amount less than fair value**	**Carrying amount above fair value**
Profit	*No profit*	*Recognise profit immediately*	*Not applicable*
Loss	*No loss*	*Not applicable*	*Recognise loss immediately*
Sale price below fair value (paragraph 50)			

Profit	No profit	Recognise profit immediately	**No profit** (note 1)
Loss not compensated by future lease payments at below market price	Recognise loss immediately	**Recognise loss immediately**	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)
Sale price above fair value (paragraph 50)			
Profit	**Defer and amortise profit**	**Defer and amortise profit**	**Defer and amortise profit (note 2)**
Loss	No loss	No loss	(note 1)

Note 1. These parts of the table represent circumstances that would have been dealt with under paragraph 52 of the Standard. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2. The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

AS 20 : EARNINGS PER SHARE

*(In this Accounting Standard, the standard portions have been set in **bold italic** type. These should be read in the context of the background material which has been set in normal type, and in the context of the 'Preface to the Statements of Accounting Standards'.)*

A limited revision this standard has been made in 2004, pursuant to which paragraphs 48 and 51 of this standard have been revised.

Accounting Standard (AS) 20, 'Earnings Per Share', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India.

An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share, should calculate and disclose earnings per share in accordance with this Standard from the aforesaid date. However, in respect of accounting periods commencing on or after 1-4-2004[1], if any such enterprise does not fall in any of the following categories, it need not disclose diluted earnings per share (both including and excluding extraordinary items) and information required by paragraph 48 (ii) of this Standard:

(i) Enterprises whose equity securities or potential equity securities are listed outside India and enterprises whose debt securities (other than potential equity securities) are listed whether in India or outside India.

(ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.

(iii) Banks including co-operative banks.

(iv) Financial institutions.

(v) Enterprises carrying on insurance business.

(vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

[1]Originally, no exemption was available to an enterprise, which had neither equity shares nor potential equity shares which were listed on a recognised stock exchange in India, but which disclosed earnings per share. It is clarified that no exemption is available even in respect of accounting periods commencing on or after 1-4-2004 to enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. It is also clarified that this Standard is not applicable to an enterprise which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India and which also does not disclose earnings per share.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) has been covered in any one or more of the above categories and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) of this Standard, until the enterprise ceases to be covered in any of the above categories for two consecutive years.

Where an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share) has previously qualified for exemption from the disclosure of diluted earnings per share (both including and excluding extraordinary items) and paragraph 48 (ii) of this Standard (being not covered by any of the above categories) but no longer qualifies for exemption in the current accounting period, this Standard becomes applicable, in its entirety, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

If an enterprise (which has neither equity shares nor potential equity shares which are listed on a recognised stock exchange in India but which discloses earnings per share), pursuant to the above provisions, does not disclose the diluted earnings per share (both including and excluding earnings per share) and information required by paragraph 48 (ii), it should disclose the fact.

The following is the text of the Accounting Standard.

OBJECTIVE

The objective of this Statement is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Statement is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining ‘earnings’, a consistently determined denominator enhances the quality of financial reporting.

SCOPE

1. This Statement should be applied by enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed but which discloses earnings per share should calculate and disclose earnings per share in accordance with this Statement.

2. In consolidated financial statements, the information required by this Statement should be presented on the basis of consolidated information[1].

3. This Statement applies to enterprises whose equity or potential equity shares are listed on a recognised stock exchange in India. An enterprise which has neither equity shares nor potential equity shares which are so listed is not required to disclose earnings per share. However, comparability in financial reporting among enterprises is enhanced if such an enterprise that is required to disclose by any statute or chooses to disclose earnings per share calculates earnings per share in accordance with the principles laid down in this Statement. In the case of a parent (holding enterprise), users of financial statements are usually concerned with, and need to be informed about, the results of operations of both the enterprise itself as well as of the group as a whole. Accordingly, in the case of such enterprises, this Statement requires the presentation of earnings per share information on the basis of consolidated financial statements as well as individual financial statements of the parent. In consolidated financial statements, such information is presented on the basis of consolidated information.

DEFINITIONS

4. For the purpose of this Statement, the following terms are used with the meanings specified:

An equity share is a share other than a preference share.

A preference share is a share carrying preferential rights to dividends and repayment of capital.

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise.

A potential equity share is a financial instrument or other contract that entitles, or may entitle, its holder to equity shares.

See also ASI 12

[1] AS – 21, 'Consolidated Financial Statements', specifies the requirements relating to consolidated financial statements.

***Share warrants** or **options** are financial instruments that give the holder the right to acquire equity shares.*

***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.*

5. Equity shares participate in the net profit for the period only after preference shares. An enterprise may have more than one class of equity shares. Equity shares of the same class have the same rights to receive dividends.

6. A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise. For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

A financial liability is any liability that is a contractual obligation to deliver cash or another financial asset to another enterprise or to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

7. Examples of potential equity shares are:

(a) debt instruments or preference shares, that are convertible into equity shares.

(b) share warrants;

(c) options including employee stock option plans under which employees of an enterprise are entitled to receive equity shares as part of their remuneration and other similar plans; and

(d) shares which would be issued upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares), such as the acquisition of a business or other assets, or shares issuable under a loan contract upon default of payment of principal or interest, if the contract so provides.

PRESENTATION

8. An enterprise should present basic and diluted earnings per share on the face of the statement of profit and loss for each class of equity shares that has a different right to

share in the net profit for the period. An enterprise should present basic and diluted earnings per share with equal prominence for all periods presented.

9. This Statement requires an enterprise to present basic and diluted earnings per share, even if the amounts disclosed are negative (a loss per share).

MEASUREMENT

Basic Earnings Per Share

10. Basic earnings per share should be calculated by dividing the net profit or loss for the period attributable to equity shareholders by the weighted average number of equity shares outstanding during the period.

EARNINGS - BASIC

11. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

12. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise *(see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies)*. The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

13. The amount of preference dividends for the period that is deducted from the net profit for the period is:

(a) the amount of any preference dividends on non-cumulative preference shares provided for in respect of the period; and

(b) the full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been provided for. The amount of preference dividends for the period does not include the amount of any preference dividends for cumulative preference shares paid or declared during the current period in respect of previous periods.

14. If an enterprise has more than one class of equity shares, net profit or loss for the period is apportioned over the different classes of shares in accordance with their dividend rights.

Per Share - Basic

15. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

16. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Appendix I illustrates the computation of weighted average number of shares.

17. In most cases, shares are included in the weighted average number of shares from the date the consideration is receivable , for example:

(a) equity shares issued in exchange for cash are included when cash is receivable;

(b) equity shares issued as a result of the conversion of a debt instrument to equity shares are included as of the date of conversion;

(c) equity shares issued in lieu of interest or principal on other financial instruments are included as of the date interest ceases to accrue;

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

(e) equity shares issued as consideration for the acquisition of an asset other than cash are included as of the date on which the acquisition is recognised; and

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

In these and other cases, the timing of the inclusion of equity shares is determined by the specific terms and conditions attaching to their issue. Due consideration should be given to the substance of any contract associated with the issue.

18. Equity shares issued as part of the consideration in an amalgamation in nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the

reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

19. Partly paid equity shares are treated as a fraction of an equity share to the extent that they were entitled to participate in dividends relative to a fully paid equity share during the reporting period.

Appendix II illustrates the computations in respect of partly paid equity shares.

20. Where an enterprise has equity shares of different nominal values but with the same dividend rights, the number of equity shares are calculated by converting all such equity shares into equivalent number of shares of the same nominal value.

21. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding, and included in the computation of basic earnings per share from the date when all necessary conditions under the contract have been satisfied.

22. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

23. Equity shares may be issued, or the number of shares outstanding may be reduced, without a corresponding change in resources. Examples include:

(a) a bonus issue;

(b) a bonus element in any other issue, for example a bonus element in a rights issue to existing shareholders;

(c) a share split; and

(d) a reverse share split (consolidation of shares).

24. In case of a bonus issue or a share split, equity shares are issued to existing shareholders for no additional consideration. Therefore, the number of equity shares outstanding is increased without an increase in resources. The number of equity shares outstanding before the event is adjusted for the proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Appendix III illustrates the computation of weighted average number of equity shares in case of a bonus issue during the period.

25. The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor:

$$\frac{\text{Fair value per share immediately prior to the exercise of rights}}{\text{Theoretical ex-rights fair value per share}}$$

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Appendix IV illustrates the computation of weighted average number of equity shares in case of a rights issue during the period.

DILUTED EARNINGS PER SHARE

26. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

27. In calculating diluted earnings per share, effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

(a) the net profit for the period attributable to equity shares is:

  (i) increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;

  (ii) increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and

(iii) adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

(b) the weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

28. For the purpose of this Statement, share application money pending allotment or any advance share application money as at the balance sheet, which is not statutorily required to be kept separately and is being utilised in the business of the enterprise, is treated in the same manner as dilutive potential equity shares for the purpose of calculation of diluted earnings per share.

EARNINGS - DILUTED

29. For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 11, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;

(b) interest recognised in the period for the dilutive potential equity shares; and

(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.

30. After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in accordance with paragraph 11 is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Appendix V illustrates the computation of diluted earnings in case of convertible debentures.

31. The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the

purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

PER SHARE - DILUTED

32. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated in accordance with paragraphs 15 and 22, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

33. The number of equity shares which would be issued on the conversion of dilutive potential equity shares is determined from the terms of the potential equity shares. The computation assumes the most advantageous conversion rate or exercise price from the standpoint of the holder of the potential equity shares.

34. Equity shares which are issuable upon the satisfaction of certain conditions resulting from contractual arrangements (contingently issuable shares) are considered outstanding and included in the computation of both the basic earnings per share and diluted earnings per share from the date when the conditions under a contract are met. If the conditions have not been met, for computing the diluted earnings per share, contingently issuable shares are included as of the beginning of the period (or as of the date of the contingent share agreement, if later). The number of contingently issuable shares included in this case in computing the diluted earnings per share is based on the number of shares that would be issuable if the end of the reporting period was the end of the contingency period. Restatement is not permitted if the conditions are not met when the contingency period actually expires subsequent to the end of the reporting period. The provisions of this paragraph apply equally to potential equity shares that are issuable upon the satisfaction of certain conditions (contingently issuable potential equity shares).

35. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

36. Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six

months weekly closing prices are usually adequate for use in computing the average price.

37. Options and other share purchase arrangements are dilutive when they would result in the issue of equity shares for less than fair value. The amount of the dilution is fair value less the issue price. Therefore, in order to calculate diluted earnings per share, each such arrangement is treated as consisting of:

(a) a contract to issue a certain number of equity shares at their average fair value during the period. The shares to be so issued are fairly priced and are assumed to be neither dilutive nor anti-dilutive. They are ignored in the computation of diluted earnings per share; and

(b) a contract to issue the remaining equity shares for no consideration. Such equity shares generate no proceeds and have no effect on the net profit attributable to equity shares outstanding. Therefore, such shares are dilutive and are added to the number of equity shares outstanding in the computation of diluted earnings per share.

Appendix VI illustrates the effects of share options on diluted earnings per share.

38. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

DILUTIVE POTENTIAL EQUITY SHARES

39. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

40. An enterprise uses net profit from continuing ordinary activities as “the control figure” that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations[2].

41. Potential equity shares are anti-dilutive when their conversion to equity shares would increase earnings per share from continuing ordinary activities or decrease loss per share from continuing ordinary activities. The effects of anti-dilutive potential equity shares are ignored in calculating diluted earnings per share.

42. In considering whether potential equity shares are dilutive or anti-dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The

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[2] AS 24, ‘Discontinuing Operations’, specifies the requirements in respect of discontinued operations.

sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Appendix VII illustrates the manner of determining the order in which dilutive securities should be included in the computation of weighted average number of shares.

43. Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

RESTATEMENT

44. If the number of equity or potential equity shares outstanding increases as a result of a bonus issue or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented. If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares. When per share calculations reflect such changes in the number of shares, that fact should be disclosed.

45. An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

46. An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

47. Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

DISCLOSURE

48. In addition to disclosures as required by paragraphs 8, 9 and 44 of this Statement, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

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

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

(c) the nominal value of shares along with the earnings per share figures[£]

49. Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the

[£] A limited revision to AS 20 hs been made in 2004 thereby revising this paragraph.This paragraph net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Statement.

50. If an enterprise discloses, in addition to basic and diluted earnings per share, per share amounts using a reported component of net profit other than net profit or loss for the period attributable to equity shareholders, such amounts should be calculated using the weighted average number of equity shares determined in accordance with this Statement. If a component of net profit is used which is not reported as a line item in the statement of profit and loss, a reconciliation should be provided between the component used and a line item which is reported in the statement of profit and loss. Basic and diluted per share amounts should be disclosed with equal prominence.

51. An enterprise may wish to disclose more information than this Statement requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of per share amounts for various components of net profit,. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in accordance with this Statement in order to ensure the comparability of the per share amounts disclosed. £

APPENDICES

Note : *These appendices are illustrative only and do not form part of the Accounting Standard. The purpose of the appendices is to illustrate the application of the Accounting Standard.*

Appendix I

Example - Weighted Average Number of Shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares Issued	*No. of Shares Bought Back*	*No. of Shares Outstanding*
1st January, 20X1	Balance at beginning of year	1,800	-	1,800
31st May,	Issue of share for cash	600	-	2,400

20X1				
1st Nov., 20X1	Buy Back of shares	-	300	2,100
31st Dec., 20X1	Balance at end of year	2,400	300	2,100

Computation of Weighted Average:

(1,800 x 5/12) + (2,400 x 5/12) + (2,100 x 2/12) = 2,100 shares.

The weighted average number of shares can alternatively be computed as follows:

(1,800 x12/12) + (600 x 7/12) - (300 x 2/12) = 2,100 shares

Appendix II

Example – Partly paid shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares issued	*Nominal value of shares*	*Amount paid*
1st January, **20X1**	Balance at beginning **of the year**	1,800	Rs. 10	Rs. 10
31st October, **20X1**	Issue of Shares	600	Rs. 10	Rs. 5

Assuming that partly paid shares are entitled to participate in the dividend to the extent of amount paid, number of partly paid equity shares would be taken as 300 for the purpose of calculation of earnings per share.

Computation of weighted average would be as follows:

(1800x12/12) + (300x2/12) = 1850 shares.

Appendix III

Example – Bonus Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X0	Rs. 18,00,000
Net profit for the year 20X1	Rs. 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 1st October 20X1	2 equity shares for each equity share outstanding at 30th September, 20X1
	20,00,000 2 = 40,00,000
Earnings per share for the year 20X1	$\frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$ = Re. 1.00
Adjusted earnings per share for the year 20X0	$\frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$ = Re. 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X0, the earliest period reported.

Appendix IV

Example – Rights Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit	Year	20X0 :	Rs. 11,00,000
	Year	20X1 :	Rs. 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares		
Rights issue	One new share for each five outstanding (i.e. 1,00,000 new shares)		
	Rights issue price : Rs. 15.00		
	Last date to exercise rights: 1st March 20X1		
Fair value of one equity share immediately prior to exercise of rights on 1st March 20X1	Rs. 21.00		

Computation of theoretical ex-rights fair value per share

$$\frac{\text{Fair value of all outstanding shares immediately prior to exercise of rights + total amount received from exercise}}{\text{Number of shares outstanding prior to exercise + number of shares issued in the exercise}}$$

$$\frac{(\text{Rs. } 21.00 \times 5{,}00{,}000 \text{ shares}) + (\text{Rs. } 15.00 \times 1{,}00{,}000 \text{ shares})}{5{,}00{,}000 \text{ shares} + 1{,}00{,}000 \text{ shares}}$$

Theoretical ex-rights fair value per share = Rs. 20.00

Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{Rs. } (21.00)}{\text{Rs. } (20.00)} = 1.05$$

Computation of earnings per share

	Year 20X0	Year 20X1
EPS for the year 20X0 as originally reported: Rs.11,00,000/5,00,000 shares	Rs. 2.20	
EPS for the year 20X0 restated for rights issue: Rs.11,00,000/(5,00,000 shares x 1.05)	Rs. 2.10	
EPS for the year 20X1 including effects of rights issue $\frac{\text{Rs. } 15{,}00{,}000}{(5{,}00{,}000 \times 1.05 \times 2/12) + (6{,}00{,}000 \times 10/12)}$		Rs. 2.55

Appendix V

Example - Convertible Debentures

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the current year	Rs. 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	Rs. 2.00
No. of 12% convertible debentures	

of Rs. 100 each	1,00,000
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	Rs. 12,00,000
Tax relating to interest expense (30%)	Rs. 3,60,000
Adjusted net profit for the current year	Rs. (1,00,00,000 + 12,00,000 – 3,60,000) = Rs. 1,08,40,000
No. of equity shares resulting from conversion of debentures	10,00,000
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 = 60,00,000
Diluted earnings per share	1,08,40,000 / 60,00,000 = Rs. 1.81

Appendix VI

Example - Effects of Share Options on Diluted Earnings Per Share

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X1	Rs. 12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	Rs. 20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	Rs. 15.00

Computation of earnings per share

	Earnings (Rs.)	***Shares***	***Earnings per share***
Net profit for the year 20X1	Rs.12,00,000		

Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			Rs. 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 x 15.00)/20.00	*	(75,000)	
Diluted earnings per share	Rs.12,00,000	5,25,000	Rs. 2.29

**The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration {see para 37(b)}*

Appendix VII

Example - Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares

(Accounting year 01-01-20XX to 31-12-20XX)

Earnings, i.e., Net profit attributable to equity shareholders	Rs. 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	Rs. 75.00
Potential Equity Shares	
Options	1,00,000 with exercise price of Rs. 60
Convertible Preference Shares	8,00,000 shares entitled to a cumulative dividend of Rs. 8 per share. Each preference share is convertible into 2 equity shares.
Attributable tax, e.g., corporate	10%

dividend tax	
12% Convertible Debentures of	Nominal amount Rs. 10,00,00,000.
Rs. 100 each	Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	*Increase in no. of Equity Shares*	*Earnings per Incremental Share*
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration {1,00,000 × (75 - 60) / 75}		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(Rs.8 × 8,00,000) + 10%(8 × 8,00,000)]	Rs.70,40,000		
No. of incremental shares {2 × 8,00,000}		16,00,000	Rs. 4.40
12% Convertible Debentures			
Increase in net profit {Rs. 10,00,00,000 × 0.12 x (1 - 0.30)}	Rs.84,00,000		
No. of incremental shares {10,00,000 × 4}		40,00,000	Rs. 2.10

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (see para 42).

Computation of Diluted Earnings Per Share

	Net Profit Attributable	*No. of Equity*	*Net Profit attributable*

	(Rs.)	Shares	Per Share (Rs.)	
As reported	1,00,00,000	20,00,000	5.00	
Options		20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti-Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from Rs. 3.06 to Rs 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is Rs. 3.06.

AS 26 : INTANGIBLE ASSETS*

Accounting Standard (AS) 26, 'Intangible Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date for the following:

(i) Enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard.

(ii) All other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 crores.

In respect of all other enterprises, the Accounting Standard comes into effect in respect of expenditure incurred on intangible items during accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date.

Earlier application of the Accounting Standard is encouraged.

In respect of intangible items appearing in the balance sheet as on the aforesaid date, *i.e.,* 1-4-2003 or 1-4-2004, as the case may be, the Standard has limited application as stated in paragraph 99. From the date of this Standard becoming mandatory for the concerned enterprises, the following stand withdrawn:

(i) Accounting Standard (AS) 8, Accounting for Research and Development;

(ii) Accounting Standard (AS) 6, Depreciation Accounting, with respect to the amortisation (depreciation) of intangible assets; and

(iii) Accounting Standard (AS) 10, Accounting for Fixed Assets - paragraphs 16.3 to 16.7, 37 and 38.

The following is the text of the Accounting Standard.

Objective

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

Scope

1. This Statement should be applied by all enterprises in accounting for intangible assets, except:

- ***(a) intangible assets that are covered by another Accounting Standard;***
- ***(b) financial assets[8];***
- ***(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and***
- ***(d) intangible assets arising in insurance enterprises from contracts with policyholders.***

£This statement should not be applied in respect of termination benefits also.

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[8] A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

2. If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Statement. For example, this Statement does not apply to:

(a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS 2, Valuation of Inventories, and AS 7, Accounting for Construction Contracts);

(b) deferred tax assets (see AS 22, Accounting for Taxes on Income);

(c) leases that fall within the scope of AS 19, Leases; and

(d) goodwill arising on an amalgamation (see AS 14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS 21, Consolidated Financial Statements).

3. This Statement applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This Statement also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

4. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee deals with an intangible asset held under a finance lease under this Statement.

5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or

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£ Termination benefits are employee benefits payable as a result of either:

(a) an enterprise's decision to terminate an employee's employment before the normal retirement date;

(b) an employee's decision to accept voluntary redundancy in exchange for those benefits (voluntary retirement)

The council of the Institute decided to make a limited revision to As 26 in 2004, pursuant to which the last sentence has been added to paragraph 1.

development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Statement does not apply to expenditure on such activities. However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Accordingly, this Statement does not apply to such items also.

Definitions

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

An <u>intangible asset</u> is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

An <u>asset</u> is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

<u>Monetary assets</u> are money held and assets to be received in fixed or determinable amounts of money.

<u>Non-monetary assets</u> are assets other than monetary assets.

<u>Research</u> is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

<u>Development</u> is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.

<u>Amortisation</u> is the systematic allocation of the depreciable amount of an intangible asset over its useful life.

<u>Depreciable amount</u> is the cost of an asset less its residual value.

<u>Useful life</u> is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

<u>Residual value</u> is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

<u>Fair value</u> of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

An <u>active market</u> is a market where all the following conditions exist:

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

An <u>impairment loss</u> is the amount by which the carrying amount of an asset exceeds its recoverable amount.[9]

<u>Carrying amount</u> is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

7. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

8. Not all the items described in paragraph 7 will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Statement does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation (see

[9] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

paragraph 55).

9. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Statement, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

14. An enterprise controls an asset if the enterprise has the power to obtain the future economic benefits flowing from the underlying resource and also can restrict the access of others to those benefits. The capacity of an enterprise to control the future economic benefits from an intangible asset would normally stem from legal rights that are enforceable in a court of law. In the absence of legal rights, it is more difficult to demonstrate control. However, legal enforceability of a right is not a necessary condition for control since an enterprise may be able to control the future economic benefits in some other way.

15. Market and technical knowledge may give rise to future economic benefits. An enterprise controls those benefits if, for example, the knowledge is protected by legal rights such as copyrights, a restraint of trade agreement (where permitted) or by a legal duty on employees to maintain confidentiality.

16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset (see paragraphs 6-18); and

(b) recognition criteria set out in this Statement (see paragraphs 20-54).

20. An intangible asset should be recognised if, and only if:

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

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

21. An enterprise should assess 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.

22. An enterprise uses judgement to assess the degree of certainty attached to the flow of future economic benefits that are attributable to the use of the asset on the basis of the evidence available at the time of initial recognition, giving greater weight to external evidence.

23. An intangible asset should be measured initially at cost.

Separate Acquisition

24. If an intangible asset is acquired separately, the cost of the intangible asset can usually be measured reliably. This is particularly so when the purchase consideration is in the form of cash or other monetary assets.

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as Part of an Amalgamation

27. An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation, paragraphs 28 to 32 of this Statement need to be considered.

28. Judgement is required to determine whether the cost (i.e. fair value) of an intangible asset acquired in an amalgamation can be measured with sufficient reliability for the purpose of separate recognition. Quoted market prices in an active market provide the most reliable measurement of fair value. The appropriate market price is usually the current bid price. If current bid prices are unavailable, the price of the most recent similar transaction may provide a basis from which to estimate fair value, provided that there has not been a significant change in economic circumstances between the transaction date and the date at which the asset's fair value is estimated.

29. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

30. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value as defined in this Statement and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

31. In accordance with this Statement:

(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor; and

(b) if the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill (see paragraph 55).

32. Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

33. In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also requires that in case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of Assets

34. An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

Internally Generated Goodwill

35. Internally generated goodwill should not be recognised as an asset.

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Statement. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

37. Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

38. It is sometimes difficult to assess whether an internally generated intangible asset

qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to-day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an enterprise applies the requirements and guidance in paragraphs 39-54 below to all internally generated intangible assets.

39. To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Statement.

40. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

41. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

42. This Statement takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Therefore, this expenditure is recognised as an expense when it is incurred.

43. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

(d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services.

Development Phase

44. An intangible asset arising from development (or from the development phase of an internal project) should be recognised if, and only if, an enterprise can demonstrate all of the following:

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

(b) its intention to complete the intangible asset and use or sell it;

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

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

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

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

45. In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

46. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

(d) the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

47. To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the *principles in Accounting Standard on Impairment of Assets[10]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash-generating units as set out in Accounting Standard on Impairment of Assets.*

48. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

49. An enterprise's costing systems can often measure reliably the cost of generating an intangible asset internally, such as salary and other expenditure incurred in securing copyrights or licences or developing computer software.

50. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

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

Cost of an Internally Generated Intangible Asset

52. The cost of an internally generated intangible asset for the purpose of paragraph 23 is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria in paragraphs 20-21 and 44. Paragraph 58 prohibits reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports.

53. The cost of an internally generated intangible asset comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and making the asset ready for its intended use. The cost includes, if applicable:

(a) expenditure on materials and services used or consumed in generating the intangible asset;

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

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[10] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

(c) any expenditure that is directly attributable to generating the asset, such as fees to register a legal right and the amortisation of patents and licences that are used to generate the asset; and

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

54. The following are not components of the cost of an internally generated intangible asset:

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Example Illustrating Paragraph 52

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was Rs. 10 lakhs, of which Rs. 9 lakhs was incurred before 1 December 20X1 and 1 lakh was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 5 lakhs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of Rs. 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The Rs. 9 lakhs expenditure incurred before 1 December 20X1 is recognised as an e

xpense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is Rs. 20 lakhs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be Rs. 19 lakhs.

At the end of the year 20X2, the cost of the production process is Rs. 21 lakhs (Rs. 1 lakh expenditure recognised at the end of 20X1 plus Rs. 20 lakhs expenditure recognised in 20X2). The enterprise recognises an impairment loss of Rs. 2 lakhs to adjust the carrying amount of the process before impairment loss (Rs. 21 lakhs) to its recoverable amount (Rs. 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets[11], are met.

Recognition of an Expense

55. Expenditure on an intangible item should be recognised as an expense when it is incurred unless:

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 19-54); or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, Accounting for Amalgamations).

56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

[11] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

57. Paragraph 55 does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be Recognised as an Asset

58. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure

59. Subsequent expenditure on an intangible asset after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

(b) the expenditure can be measured and attributed to the asset reliably.

If these conditions are met, the subsequent expenditure should be added to the cost of the intangible asset.

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

61. Consistent with paragraph 50, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

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

Amortisation

Amortisation Period

63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

65. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that *their useful life will be short.*

66. Estimates of the useful life of an intangible asset generally become less reliable as the length of the useful life increases. This Statement adopts a presumption that the useful life of intangible assets is unlikely to exceed ten years.

67. In some cases, there may be persuasive evidence that the useful life of an intangible asset will be a specific period longer than ten years. In these cases, the presumption that the useful life generally does not exceed ten years is rebutted and the enterprise:

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(d) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

Examples

A. An enterprise has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro-electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

The enterprise amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

The enterprise amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

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

(a) the legal rights are renewable; and

(b) renewal is virtually certain.

70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

71. The following factors, among others, indicate that renewal of a legal right is virtually certain:

(a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;

(b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and

(c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

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

73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

74. Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see AS 2, Valuation of Inventories).

Residual Value

75. The residual value of an intangible asset should be assumed to be zero unless:

(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or

(b) there is an active market for the asset and:

(i) residual value can be determined by reference to that market; and

(ii) it is probable that such a market will exist at the end of the asset's useful life.

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value.

Review of Amortisation Period and Amortisation Method

78. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

79. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

80. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount - Impairment Losses

81. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[12]. That Standard explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

82. If an impairment loss occurs before the end of the first annual accounting period commencing after acquisition for an intangible asset acquired in an amalgamation in the nature of purchase, the impairment loss is recognised as an adjustment to both the amount assigned to the intangible asset and the goodwill (capital reserve) recognised at the date of the amalgamation. However, if the impairment loss relates to specific events or changes in circumstances occurring after the date of acquisition, the impairment loss is recognised under Accounting Standard on Impairment of Assets and not as an adjustment to the amount assigned to the goodwill (capital reserve) recognised at the date of acquisition.

83. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

- ***(a) an intangible asset that is not yet available for use; and***
- ***(b) an intangible asset that is amortised over a period exceeding ten years from the date when the asset is available for use.***

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

84. The ability of an intangible asset to generate sufficient future economic benefits to recover its cost is usually subject to great uncertainty until the asset is available for use. Therefore, this Statement requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

85. It is sometimes difficult to identify whether an intangible asset may be impaired because, among other things, there is not necessarily any obvious evidence of obsolescence. This difficulty arises particularly if the asset has a long useful life. As a consequence, this Statement requires, as a minimum, an annual calculation of the recoverable amount of an intangible asset if its useful life exceeds ten years from the date when it becomes available for use.

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[12] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

86. The requirement for an annual impairment test of an intangible asset applies whenever the current total estimated useful life of the asset exceeds ten years from when it became available for use. Therefore, if the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the impairment test required under paragraph 83(b) and also makes the disclosure required under paragraph 94(a).

Retirements and Disposals

87. An intangible asset should be derecognised (eliminated from the balance sheet) on disposal or when no future economic benefits are expected from its use and subsequent disposal.

88. Gains or losses arising from the retirement or disposal of an intangible asset should be determined as the difference between the net disposal proceeds and the carrying amount of the asset and should be recognised as income or expense in the statement of profit and loss.

89. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets[13], and recognises any impairment loss accordingly.

Disclosure

General

90. The financial statements should disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- ***(a) the useful lives or the amortisation rates used;***
- ***(b) the amortisation methods used;***
- ***(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;***
- (d) a reconciliation of the carrying amount at the beginning and end of the period showing:

[13] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

(i) additions, indicating separately those from internal development and through amalgamation;

(ii) retirements and disposals;

(iii) impairment losses recognised in the statement of profit and loss during the period (if any);

(iv) impairment losses reversed in the statement of profit and loss during the period (if any);

(v) amortisation recognised during the period; and

(vi) other changes in the carrying amount during the period.

91. A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

(a) brand names;

(b) mastheads and publishing titles;

(c) computer software;

(d) licences and franchises;

(e) copyrights, and patents and other industrial property rights, service and operating rights;

(f) recipes, formulae, models, designs and prototypes; and

(g) intangible assets under development.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

92. An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets[14] in addition to the information required by paragraph 90(d)(iii) and (iv).

93. An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

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[14] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

94. The financial statements should also disclose:

(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;

(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;

(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and

(d) the amount of commitments for the acquisition of intangible assets.

95. When an enterprise describes the factor(s) that played a significant role in determining the useful life of an intangible asset that is amortised over more than ten years, the enterprise considers the list of factors in paragraph 64.

Research and Development Expenditure

96. The financial statements should disclose the aggregate amount of research and development expenditure recognised as an expense during the period.

97. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities (see paragraphs 53-54 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 96).

Other Information

98. An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

99. Where, on the date of this Statement coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Statement and the period determined under paragraph 63 has expired on the date of this Statement coming into effect, the carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Statement coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

(b) if the remaining period as per the accounting policy followed by the enterprise:

(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

(ii) is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Statement, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

100. Appendix B illustrates the application of paragraph 99.

Appendix A

This Appendix, which is illustrative and does not form part of the Accounting Standard, provides illustrative application of the principles laid down in the Standard to internal use software and web-site costs. The purpose of the appendix is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

I. Illustrative Application of the Accounting Standard to Internal Use Computer Software

Computer software for internal use can be internally generated or acquired.

Internally Generated Computer Software

1. Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

2. The stages of development of internally generated software may be categorised into the following two phases:

Preliminary project stage, i.e., the research phase

Development phase

Preliminary project stage

3. At the preliminary project stage the internally generated software should not be recognised as an asset. Expenditure incurred in the preliminary project stage should be recognised as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise can not demonstrate that an asset exists from which future economic benefits are probable.

4. When a computer software project is in the preliminary project stage, enterprises are likely to:

(a) Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system.

(b) Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

(c) Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software. Should the software run on a mainframe or a client server system.

(d) Determine that the technology needed to achieve performance requirements exists.

(e) Select a consultant to assist in the development and/or installation of the software.

Development Stage

5. An internally generated software arising at the development stage should be recognised as an asset if, and only if, an enterprise can demonstrate all of the following:

(a) the technical feasibility of completing the internally generated software so that it will be available for internal use;

(b) the intention of the enterprise to complete the internally generated software and use it to perform the functions intended. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;

(c) the ability of the enterprise to use the software;

(d) how the software will generate probable future economic benefits. Among other things, the enterprise should demonstrate the usefulness of the software;

(e) the availability of adequate technical, financial and other resources to complete the development and to use the software; and

(f) the ability of the enterprise to measure the expenditure attributable to the software during its development reliably.

6. Examples of development activities in respect of internally generated software include:

(a) Design including detailed program design – which is the process of detail design of computer software that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

(b) Coding which includes generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

At the end of these stages of the development activity, the enterprise has a working model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

(c) Testing which is the process of performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

At the end of the testing process, the enterprise has a master version of the internal use software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

7. The cost of an internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of this Statement and paragraph 5 above. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

8. The cost of an internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost include:

(a) expenditure on materials and services used or consumed in developing the software;

(b) the salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) any expenditure that is directly attributable to generating software; and

(d) overheads that are necessary to generate the software and that can be allocated on a reasonable and consistent basis to the software (For example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads are made on basis similar to those used in allocating the overhead to inventories.

9. The following are not components of the cost of an internally generated software:

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

(b) clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

(c) expenditure on training the staff to use the internally generated software.

Software Acquired for Internal Use

10. The cost of a software acquired for internal use should be recongised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this Statement.

11. The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Statement need to be considered, as appropriate.

Subsequent expenditure

12. Enterprises may incur considerable cost in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) the expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognised as an expense when, and only when, the restoration or maintenance work is carried out.

Amortisation period

13. The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortisation should commence when the software is available for use.

14. As per this Statement, there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.

Amortisation method

15. The amortisation method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern can not be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of a software used in a production process is included in the carrying amount of inventories.

II. Illustrative Application of the Accounting Standard to Web-Site Costs

1. An enterprise may incur internal expenditures when developing, enhancing and maintaining its own web site. The web site may be used for various purposes such as promoting and advertising products and services, providing electronic services, and selling products and services.

2. The stages of a web site's development can be described as follows:

(a) Planning – includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences;

(b) Application and Infrastructure Development – includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing; and

(c) Graphical Design and Content Development – includes designing the appearance of web pages and creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed and the web site is available for use, the web site commences an operating stage. During this stage, an enterprise maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. The expenditures for purchasing, developing, maintaining and enhancing hardware (e.g., web servers, staging servers, production servers and Internet connections) related to a web site are not accounted for under this Statement but are accounted for under AS 10, Accounting for Fixed Assets. Additionally, when an enterprise incurs an expenditure for having an Internet service provider host the enterprise's web site on it's own servers connected to the Internet, the expenditure is recognised as an expense.

5. An intangible asset is defined in paragraph 6 of this Statement as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Paragraph 7 of this Statement provides computer software as a common example of an intangible asset. By analogy, a web site is another example of an intangible asset. Accordingly, a web site developed by an enterprise for its own use is an internally generated intangible asset that is subject to the requirements of this Statement.

6. An enterprise should apply the requirements of this Statement to an internal expenditure for developing, enhancing and maintaining its own web site. Paragraph 55 of this Statement provides expenditure on an intangible item to be recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 19-54 of the Statement. Paragraph 56 of the Statement requires expenditure on start-up activities to be recognised as an expense when incurred. Developing a web site by an enterprise for its own use is not a start-up activity to the extent that an internally generated intangible asset is created. An enterprise applies the requirements and guidance in paragraphs 39-54 of this Statement to an expenditure incurred for developing its own web site in addition to the general requirements for recognition and initial measurement of an intangible asset. The cost of a web site, as described in paragraphs 52-54 of this Statement, comprises

all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

The enterprise should evaluate the nature of each activity for which an expenditure is incurred (e.g., training employees and maintaining the web site) and the web site's stage of development or post-development:

(a) Paragraph 41 of this Statement requires an expenditure on research (or on the research phase of an internal project) to be recognised as an expense when incurred. The examples provided in paragraph 43 of this Statement are similar to the activities undertaken in the Planning stage of a web site's development. Consequently, expenditures incurred in the Planning stage of a web site's development are recognised as an expense when incurred.

(b) Paragraph 44 of this Statement requires an intangible asset arising from the development phase of an internal project to be recognised if an enterprise can demonstrate fulfillment of the six criteria specified. Application and Infrastructure Development and Graphical Design and Content Development stages are similar in nature to the development phase. Therefore, expenditures incurred in these stages should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements for recognition and initial measurement of an intangible asset, an enterprise can demonstrate those items described in paragraph 44 of this Statement. In addition,

(i) an enterprise may be able to demonstrate how its web site will generate probable future economic benefits under paragraph 44(d) by using the principles in Accounting Standard on Impairment of Assets[15]. This includes situations where the web site is developed solely or primarily for promoting and advertising an enterprise's own products and services. Demonstrating how a web site will generate probable future economic benefits under paragraph 44(d) by assessing the economic benefits to be received from the web site and using the principles in Accounting Standard on Impairment of Assets, may be particularly difficult for an enterprise that develops a web site solely or primarily for advertising and promoting its own products and services; information is unlikely to be available for reliably estimating the amount obtainable from the sale of the web site in an arm's length transaction, or the future cash inflows and outflows to be derived from its continuing use and ultimate disposal. In this circumstance, an enterprise determines the future economic benefits of the cash-generating unit to which the

[15] Accounting Standard (AS)28 , 'Impairment of Assets ', specifies the requirements relating to impairment of assets.

web site belongs, if it does not belong to one. If the web site is considered a corporate asset (one that does not generate cash inflows independently from other assets and their carrying amount cannot be fully attributed to a cash-generating unit), then an enterprise applies the 'bottom-up' test and/or the 'top-down' test under Accounting Standard on Impairment of Assets.

(ii) an enterprise may incur an expenditure to enable use of content, which had been purchased or created for another purpose, on its web site (e.g., acquiring a license to reproduce information) or may purchase or create content specifically for use on its web site prior to the web site becoming available for use. In such circumstances, an enterprise should determine whether a separate asset, is identifiable with respect to such content (e.g., copyrights and licenses), and if a separate asset is not identifiable, then the expenditure should be included in the cost of developing the web site when the expenditure meets the conditions in paragraph 44 of this Statement. As per paragraph 20 of this Statement, an intangible asset is recognised if, and only if, it meets specified criteria, including the definition of an intangible asset. Paragraph 52 indicates that the cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the specified recognition criteria. When an enterprise acquires or creates content, it may be possible to identify an intangible asset (e.g., a license or a copyright) separate from a web site. Consequently, an enterprise determines whether an expenditure to enable use of content, which had been created for another purpose, on its web site becoming available for use results in a separate identifiable asset or the expenditure is included in the cost of developing the web site.

(c) the operating stage commences once the web site is available for use, and therefore an expenditure to maintain or enhance the web site after development has been completed should be recognised as an expense when it is incurred unless it meets the criteria in paragraph 59 of the Statement. Paragraph 60 explains that if the expenditure is required to maintain the asset at its originally assessed standard of performance, then the expenditure is recognised as an expense when incurred.

7. An intangible asset is measured subsequent to initial recognition by applying the requirements in paragraph 62 of this Statement. Additionally, since paragraph 68 of the Statement states that an intangible asset always has a finite useful life, a web site that is recognised as an asset is amortised over the best estimate of its useful life. As indicated in paragraph 65 of the Statement, web sites are susceptible to technological obsolescence, and given the history of rapid changes in technology, their useful life will be short.

8. The following table illustrates examples of expenditures that occur within each of the *stages described in paragraphs 2 and 3 above and application of paragraphs 5 and 6 above. It is not intended to be a comprehensive checklist of expenditures that might be incurred.*

Nature of Expenditure	*Accounting treatment*
Planning undertaking feasibility studies defining hardware and software specifications evaluating alternative products and suppliers selecting preferences	Expense when incurred
Application and Infrastructure Development purchasing or developing hardware	Apply the requirements of AS 10
obtaining a domain name developing operating software (e.g., operating system and server software) developing code for the application installing developed applications on the web server stress testing	Expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Graphical Design and Content Development designing the appearance (e.g., layout and colour) of web pages creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. Examples of content include information about an enterprise, products or services offered for sale, and topics that subscribers access	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
OPERATING updating graphics and revising content adding new functions, features and content registering the web site with search engines	Expense when incurred, unless in rare circumstances it meets the criteria in paragraph 59, in which

backing up data reviewing security access analysing usage of the web site	case the expenditure is included in the cost of the web site
Other selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use clearly identified inefficiencies and initial operating losses incurred before the web site achieves planned performance (e.g., false start testing) training employees to operate the web site	Expense when incurred

Appendix B

This Appendix, which is illustrative and does not form part of the Accounting Standard, provides illustrative application of the requirements contained in paragraph 99 of this Accounting Standard in respect of transitional provisions.

Example 1 – Intangible Item was not amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 10 lakhs as on 1-4-2003. The item was acquired for Rs. 10 lakhs on April 1, 1990 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1990.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of the intangible item of Rs. 10 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Example 2 – Intangible Item is being amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 1991 and was available for use from that date. The enterprise has been following a policy of amortising the item over a period of 20 *years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1991.*

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of Rs. 8 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Example 3 – Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is shorter.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 8 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 5 years on straight line basis. Applying paragraph 63, the enterprise determines the amortisation period to be 8 years, being the best estimate of its useful life, from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 2 years as per the accounting policy followed by the enterprise which is shorter as compared to the balance of amortisation period determined by applying paragraph 63, i.e., 5 years. Accordingly, the enterprise would be required to amortise the intangible item over the remaining 2 years as per the accounting policy followed by the enterprise

Example 4 – Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is longer.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 18 lakhs as on 1-4-2003. The item was acquired for Rs. 24 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 12 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 9 years as per the accounting policy followed by the enterprise which is longer as compared to the balance of period stipulated in paragraph 63, i.e., 7 years. Accordingly, the enterprise would be required to restate the carrying amount of intangible item on 1-4-2003 at Rs. 16.8 lakhs (Rs. 24 lakhs – 3xRs. 2.4 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 1.2 lakhs (Rs. 18 lakhs-Rs. 16.8 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of Rs. 16.8 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

Example 5 – Intangible Item is not amortised and amortisation period determined under paragraph 63 has not expired.

An intangible item is appearing in the balance sheet of A Ltd. at Rs. 20 lakhs as on 1-4-2003. The item was acquired for Rs. 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the enterprise would be required to restate the carrying amount of intangible item at Rs. 14 lakhs (Rs. 20 lakhs – 3xRs. 2 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of Rs. 6 lakhs (Rs. 20 lakhs-Rs. 14 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of Rs. 14 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

AS – 29 : PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS

Accounting Standard (AS) 29, 'Provisions, Contingent Liabilities and Contingent Assets', issued by the Council of the Institute of Chartered Accountants of India, comes into effect in respect of accounting periods commencing on or after 1-4-2004. This Standard is mandatory in nature from that date:

(a) in its entirety, for the enterprises which fall in any one or more of the following categories, at any time during the accounting period:

- (i) Enterprises whose equity or debt securities are listed whether in India or outside India.
- (ii) Enterprises which are in the process of listing their equity or debt securities as evidenced by the board of directors' resolution in this regard.
- (iii) Banks including co-operative banks.
- (iv) Financial institutions.
- (v) Enterprises carrying on insurance business.
- (vi) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 50 crore. Turnover does not include 'other income'.

(vii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 10 crore at any time during the accounting period.

(viii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

(b) in its entirety, except paragraph 67, for the enterprises which do not fall in any of the categories in (a) above but fall in any one or more of the following categories:

(i) All commercial, industrial and business reporting enterprises, whose turnover for the immediately preceding accounting period on the basis of audited financial statements exceeds Rs. 40 lakhs but does not exceed Rs. 50 crore. Turnover does not include 'other income'.

(ii) All commercial, industrial and business reporting enterprises having borrowings, including public deposits, in excess of Rs. 1 crore but not in excess of Rs. 10 crore at any time during the accounting period.

(iii) Holding and subsidiary enterprises of any one of the above at any time during the accounting period.

(c) in its entirety, except paragraphs 66 and 67, for the enterprises, which do not fall in any of the categories in (a) and (b) above.

Where an enterprise has been covered in any one or more of the categories in (a) above and subsequently, ceases to be so covered, the enterprise will not qualify for exemption from paragraph 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) above for two consecutive years.

Where an enterprise has been covered in any one or more of the categories in (a) or (b) above and subsequently, ceases to be covered in any of the categories in (a) and (b) above, the enterprise will not qualify for exemption from paragraphs 66 and 67 of this Standard, until the enterprise ceases to be covered in any of the categories in (a) and (b) above for two consecutive years.

Where an enterprise has previously qualified for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, but no longer qualifies for exemption from paragraph 67 or paragraphs 66 and 67, as the case may be, in the current accounting period, this Standard becomes applicable, in its entirety or, in its entirety except paragraph 67, as the case may be, from the current period. However, the relevant corresponding previous period figures need not be disclosed.

An enterprise, which, pursuant to the above provisions, does not disclose the information required by paragraph 67 or paragraphs 66 and 67, as the case may be, should disclose the fact.

From the date of this Accounting Standard becoming mandatory (in its entirety or with the exception of paragraph 67 or paragraphs 66 and 67, as the case may be), all paragraphs of Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1 (a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16), stand withdrawn.

The following is the text of the Accounting Standard.

OBJECTIVE

The objective of this Statement 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 Statement is also to lay down appropriate accounting for contingent assets.

SCOPE

1. ***This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:***

    (a) those resulting from financial instruments[16] that are carried at fair value;

    (b) those resulting from executory contracts;

    (c) those arising in insurance enterprises from contracts with policy-holders; and

    (d) those covered by another Accounting Standard.

2. This Statement applies to financial instruments (including guarantees) that are not carried at fair value.

3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.

4. This Statement applies to provisions, contingent liabilities and contingent assets of

It is clarified that paragraphs of AS 4 that deal with contingencies would remain operational to the extent they deal with impairment of assets not covered by other Indian Accounting Standard.

[16] For the purpose of this Statement, the term ‘financial instruments’ shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

insurance enterprises other than those arising from contracts with policy-holders.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:

   (a) construction contracts (see AS 7, Construction Contracts);

   (b) taxes on income (see AS 22, Accounting for Taxes on Income);

   (c) leases (see AS 19, Leases); and

   (d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).

6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Statement does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Statement does not change the requirements of AS 9.

7. This Statement defines provisions as liabilities which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement.

8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Statement. Accordingly, this Statement neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9. This Statement applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

DEFINITIONS

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

    A <u>provision</u> is a liability which can be measured only by using a substantial degree of estimation.

    A <u>liability</u> 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 <u>obligating event</u> is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

A <u>contingent liability</u> is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

(ii) a reliable estimate of the amount of the obligation cannot be made.

A <u>contingent asset</u> is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.

<u>Present obligation</u> - 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.

<u>Possible obligation</u> - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

A <u>restructuring</u> 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.

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

12. Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is

involved with regard to the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

13. In this Statement, the term 'contingent' is used for liabilities and assets that are not recognised because their existence 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. In addition, the term 'contingent liability' is used for liabilities that do not meet the recognition criteria.

RECOGNITION

Provisions

14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

PRESENT OBLIGATION

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

Past Event

16. 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.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed -- indeed the obligation may be to the public at large.

20. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

21. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement[17], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

23. Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

RELIABLE ESTIMATE OF THE OBLIGATION

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 68).

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[17] The interpretation of 'probable' in this Statement as 'more likely than not' does not necessarily apply in other Accounting Standards.

CONTINGENT LIABILITIES

26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14).

29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

CONTINGENT ASSETS

30. An enterprise should not recognise a contingent asset.

31. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

33. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

34. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

MEASUREMENT

Best Estimate

35. **The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.**

36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

37. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

RISKS AND UNCERTAINTIES

38. **The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.**

39. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

40. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 67(b).

FUTURE EVENTS

41. **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.**

42. Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its

life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

43. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

EXPECTED DISPOSAL OF ASSETS

44. **Gains from the expected disposal of assets should not be taken into account in measuring a provision.**

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

REIMBURSEMENTS

46. **Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.**

47. **In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.**

48. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.

49. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

50. In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

51. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

53. A provision should be used only for expenditures for which the provision was originally recognised.

54. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

APPLICATION OF THE RECOGNITION AND MEASUREMENT RULES

Future Operating Losses

55. Provisions should not be recognised for future operating losses.

56. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

57. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

58. The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

59. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.

60. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

61. An enterprise cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

62. A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

63. A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

64. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

65. As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

DISCLOSURE

66. 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.

67. 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.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 35-45;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

69. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 67 (a) and (b) and 68 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

70. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 66-68 in a way that shows the link between the provision and the contingent liability.

71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

APPENDIX A

Tables - Provisions, Contingent Liabilities and Reimbursements

The purpose of this appendix is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.

PROVISIONS AND CONTINGENT LIABILITIES

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be	**There is a possible obligation or a present obligation that may, but probably will not, require**	**There is a possible obligation or a present obligation where the likelihood of an outflow of**

made of the amount of obligation.	**an outflow of resources.**	**resources is remote.**
A provision is recognised (paragraph 14). Disclosures are required for the provision (paragraphs 66 and 67)	No provision is recognised (paragraph 26). Disclosures are required for the contingent liability (paragraph 68).	No provision is recognised (paragraph 26). No disclosure is required (paragraph 68).

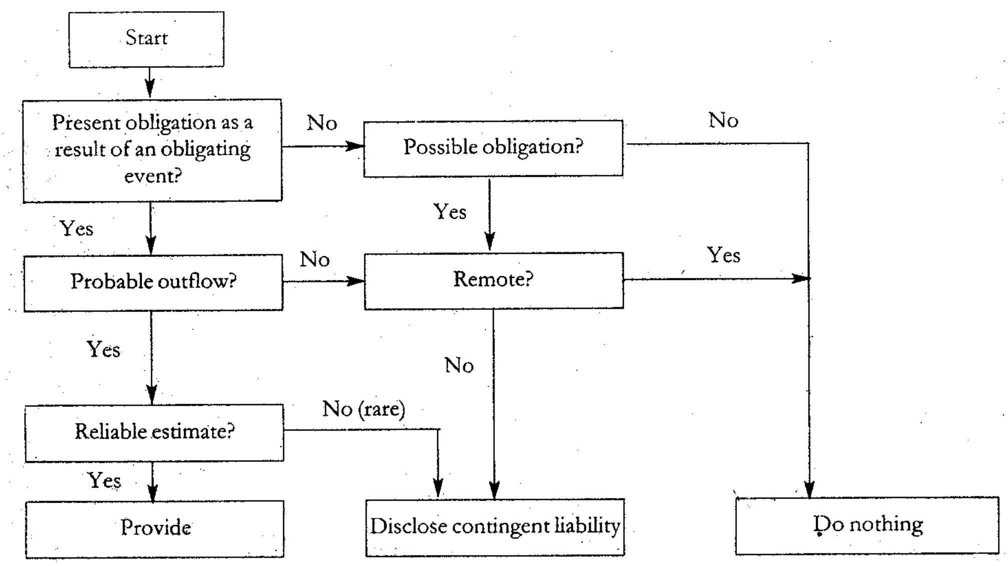
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	**The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.**	**The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.**
The enterprise has no liability for the amount to be reimbursed (paragraph 50). No disclosure is required.	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 46 and 47). The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 67(c)).	The expected reimbursement is not recognised as an asset (paragraph 46). The expected reimbursement is disclosed (paragraph 67(c)).

Appendix B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

APPENDIX C

Examples: Recognition

This appendix illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the examples have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some examples the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the examples.

The cross references provided in the examples indicate paragraphs of the Accounting Standard that are particularly relevant. The appendix should be read in the context of the full text of the Accounting Standard.

EXAMPLE 1: WARRANTIES

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Example 2: Contaminated Land - Legislation Virtually Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

EXAMPLE 3: OFFSHORE OILFIELD

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

EXAMPLE 4: REFUNDS POLICY

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement - Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 11, 14 and 23).

EXAMPLE 5: LEGAL REQUIREMENT TO FIT SMOKE FILTERS

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 March 2006

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Example 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

EXAMPLE 7: A SINGLE GUARANTEE

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

EXAMPLE 8: A COURT CASE

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

EXAMPLE 9A: REFURBISHMENT COSTS - NO LEGISLATIVE REQUIREMENT

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

EXAMPLE 9B: REFURBISHMENT COSTS - LEGISLATIVE REQUIREMENT

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

APPENDIX D

Example: Disclosures

The appendix is illustrative only and does not form part of the Accounting Standard. The purpose of the appendix is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

An example of the disclosures required by paragraph 67 is provided below.

EXAMPLE 1 WARRANTIES

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of Rs. 60,000 has been recognised. The following information is disclosed:

A provision of Rs. 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

An example is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

EXAMPLE 2 DISCLOSURE EXEMPTION

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of Rs. 1000 lakhs. The enterprise recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 66 and 67 of the Statement. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of Rs. 1000 lakhs. The information usually required by AS 29, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

APPENDIX E

Note: *This Appendix is not a part of the Accounting Standard. The purpose of this appendix is only to bring out the major differences between Accounting Standard 29 and corresponding International Accounting Standard (IAS) 37.*

Comparison with IAS 37, Provisions, Contingent Liabilities and Contingent Assets (1998)

The Accounting Standard differs from International Accounting Standard (IAS) 37, Provisions, Contingent Liabilities and Contingent Assets, in the following major respects:

1. *Discounting of Provisions*

IAS 37 requires that where the effect of the time value of money is material, the amount of a provision should be the present value of the expenditures expected to be required to settle the obligation. On the other hand, the Accounting Standard requires that the amount of a provision should not be discounted to its present value. The reason for not requiring discounting is that, at present, in India, financial statements are prepared generally on historical cost basis and not on present value basis.

2. Onerous Contracts

IAS 37 requires that if an enterprise has a contract that is onerous, the present obligation under the contract should be recognised and measured as a provision. For this purpose, IAS 37 defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

It is decided that in respect of onerous contracts, on which IAS 37 is applicable, present obligation should not be required to be recognised. This is because recognition of estimated loss in case of an onerous contract amounts to recognition of loss of future periods in the current year's profit and loss account thereby distorting the operating results of the current year. Further, it may not be feasible to determine, in all cases, whether a particular contract is onerous or not because which costs are unavoidable may be a matter of subjective judgement. Accordingly, the provisions of IAS 37 relating to onerous contracts including the definition of 'onerous contract' have been omitted from the Accounting Standard.

3. Constructive obligation and Restructurings

IAS 37 deals with 'constructive obligation' in the context of creation of a provision. The effect of recognising provision on the basis of constructive obligation is that, in some cases, provision will be required to be recognised at an early stage. For example, in case of a restructuring, a constructive obligation arises when an enterprise has a detailed formal plan for the restructuring and the enterprise has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it. It is felt that merely on the basis of a detailed formal plan and announcement thereof, it would not be appropriate to recognise a provision since a liability can not be considered to be crystalised at this stage. Further, the judgment whether the management has raised valid expectations in those affected may be a matter of considerable argument.

In view of the above, the Accounting Standard does not deal with 'constructive obligation'. Thus, in situations such as restructuring, general recognition criteria are required to be applied.

4. Contingent Assets

Both the Accounting Standard and IAS 37 require that an enterprise should not recognise a contingent asset. However, IAS 37 requires certain disclosures in respect of contingent assets in the financial statements where an inflow of economic benefits is probable. In contrast to this, as a measure of prudence, the Accounting Standard does not even require contingent assets to be disclosed in the financial statements. The Standard recognises that contingent asset is usually disclosed in the report of the approving authority where an inflow of economic benefits is probable.

5. Definitions

The definitions of the terms 'legal obligation', 'constructive obligation' and 'onerous contract' contained in IAS 37 have been omitted from the Accounting Standard, as a consequence to above departures from IAS 37. Further, the definitions of the terms 'provision' and 'obligating event' contained in IAS 37 have been modified as a consequence to above departures from IAS 37. In the Accounting Standard, the definitions of the terms 'present obligation' and 'possible obligation' have been added as compared to IAS 37 with a view to bring more clarity.

Limited Revision to Accounting Standard (AS) 29,

Provisions, Contingent Liabilities and Contingent Assets

The Council of the Institute of Chartered Accountants of India has decided to make the following limited revisions of Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets.

Paragraphs 1, 3 and 5 of AS 29 have been decided to be modified as under (modifications are shown as underlined):

Scope

1. This Statement should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:

(a) those resulting from financial instruments that are carried at flair value;

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

(c) those arising in insurance enterprises from contracts with policy-holders; and

(d) those covered by another Accounting Standard."

"3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Statement does not apply to executory contracts unless they are onerous."

"5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS 7, Construction Contracts);

(b) taxes on income (see AS22, Accounting for Taxes on income);

(c) leases (see AS 19, Leases). However, as AS 19 contains no specific requirements to deal with operating leases that have become onerous, this Statement applies to such cases; and

(d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).

Pursuant to the above limited revision, paragraph 2 of Appendix E (dealing with comparison of AS 29 with IAS 37) to AS 29 stands withdrawn. Consequently, the numbering of subsequent paragraphs of Appendix E is also changed.

The limited revision comes into effect in respect of accounting periods commencing on or after April 1, 2006.

As a consequence to the Limited Revision to AS 29, Accounting Standards Interpretation (ASI) 30 has been issued.

APPENDIX III

ACCOUNTING STANDARDS INTERPRETATIONS

The authority of the Accounting Standards Interpretations (ASI) is the same as that of the Accounting Standard to which it relates. The contents of this ASI are intended for the limited purpose of the Accounting Standard to which it relates. ASI is intended to apply only to material items. The Institute of Chartered Accountants of India has, so far, issued 30 ASIs. The ASIs relevant for the Accounting Standards covered under the PCC curriculum are as follows:

Accounting Standards Interpretation (ASI) 1

Substantial Period of Time

Accounting Standard (AS) 16, Borrowing Costs

ISSUE

1. Accounting Standard (AS) 16, Borrowing Costs, defines the term 'qualifying asset' as "an asset that necessarily takes a substantial period of time to get ready for its intended use or sale".

2. The issue is what is the meaning of the expression 'substantial period of time' for the purpose of this definition.

CONSENSUS

3. The issue as to what constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale should be considered.

4. The following assets ordinarily take twelve months or more to get ready for intended use or sale unless the contrary can be proved by the enterprise:

   i. assets that are constructed or otherwise produced for an enterprise's own use, e.g., assets constructed under major capital expansions.

   ii. assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example, ships or real estate developments).

5. In case of inventories, substantial period of time is considered to be involved where time is the major factor in bringing about a change in the condition of inventories. For example, liquor is often required to be kept in store for more than twelve months for maturing.

BASIS FOR CONCLUSION

6. Paragraph 6 of AS 16 provides that *"Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Statement. Other borrowing costs should be recognised as an expense in the period in which they are incurred"*.

This paragraph recognises that borrowing costs should be expensed except where they are directly attributable to acquisition, construction or production of a qualifying asset. To qualify for capitalisation of borrowing costs, the asset should take a long period of time to get ready for its intended use or sale.

7. Paragraph 5 of AS 16 gives examples of manufacturing plants, power generation facilities etc. as qualifying assets. In these cases, normally a period of more than twelve months is required for getting them ready for their intended use. Therefore, a rebuttable presumption of a period of twelve months is considered "substantial" period of time.

8. Paragraph 5 of AS 16 provides, inter alia, that *"inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets." Paragraph 12 of Accounting Standard (AS) 2, Valuation of Inventories, provides that "Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories".* It is only in exceptional cases, where time is a major factor in bringing about change in the condition of inventories that borrowing costs are included in the valuation of inventories.

Accounting Standards Interpretation (ASI) 10

Interpretation of paragraph 4(e) of AS 16

Accounting Standard (AS) 16, Borrowing Costs

ISSUE

1. Paragraph 4 (e) of AS 16, 'Borrowing Costs', provides that borrowing costs may include "exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs".

2. The issue is which exchange differences are covered under paragraph 4 (e) of AS 16.

CONSENSUS

3. Paragraph 4 (e) of AS 16 covers exchange differences on the amount of principal of the foreign currency borrowings to the extent of difference between interest on local currency borrowings and interest on foreign currency borrowings. For this purpose, the interest rate for the local currency borrowings should be considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings. If the difference between the interest on local currency borrowings and the interest on foreign currency borrowings is equal to or more than the exchange difference on the amount of principal of the foreign currency borrowings, the entire amount of exchange difference is covered under paragraph 4 (e) of AS 16.

The Appendix to this Interpretation illustrates the application of the above requirements.

BASIS FOR CONCLUSIONS

4. Enterprises often borrow in foreign currency at a lower interest rate as an alternative to borrowing locally in rupees, at a higher rate. However, the likely currency depreciation and resulting exchange loss often offset, fully or partly, the difference in the interest rates. In such cases, the exchange difference on the foreign currency borrowings to the extent of the difference between interest on local currency borrowing and interest on foreign currency borrowing, is regarded as an adjustment to the interest costs. This exchange difference is, in substance, a borrowing cost. In case of an enterprise, which instead of borrowing locally at a higher interest rate, borrows in foreign currency on the basis that the interest cost on foreign currency borrowings as adjusted by the exchange fluctuations, is expected to be less than the interest cost of an equivalent rupee borrowing, it is not appropriate to consider only the explicit interest cost on the foreign currency borrowing as the borrowing costs. In such a case, to the extent the exchange differences are regarded as an adjustment to the interest costs, as explained above, the same should also be considered as borrowing costs and accounted for accordingly with a view to reflect economic reality. Accordingly, such an exchange difference is covered under AS 16.

5. The explicit interest cost, including exchange difference thereon, if any, is covered under paragraph 4 (a) of AS 16, which provides that borrowing costs may include interest and commitment charges on bank borrowing and other short term and long term borrowings. Accordingly, the intention of paragraph 4(e) of AS 16 is to cover exchange differences on the amount of the principal of the foreign currency borrowings. Further, since paragraph 4 (e) uses the words ‘to the extent that they are regarded as an adjustment to interest costs’, the entire exchange difference on principal amount is not covered by paragraph 4 (e). Since, the

difference between interest on local currency borrowings and interest on foreign currency borrowings, is regarded as an adjustment to the interest costs, only the exchange difference to the extent of such difference is covered by paragraph 4 (e) of AS 16. The entire exchange difference on the principal amount is regarded as an adjustment to the interest cost only in a situation where the difference between interest on local currency borrowings and interest on foreign currency borrowings is equal to or more than the exchange difference.

APPENDIX

Note: *This appendix is illustrative only and does not form part of the Accounting Standards Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.*

Facts:

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was Rs. 45 per USD. The exchange rate, as at March 31, 20X4, is Rs. 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent per annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

i. Interest for the period = USD 10,000 x 5%x Rs. 48/USD = Rs. 24,000/-

ii. Increase in the liability towards the principal amount = USD 10,000 x (48-45) = Rs. 30,000/-

iii. Interest that would have resulted if the loan was taken in Indian currency = USD 10000 x 45 x 11%). = Rs. 49,500

iv. Difference between interest on local currency borrowing and foreign currency borrowing = Rs. 49,500 - Rs. 24,000 = Rs. 25,500

Therefore, out of Rs. 30,000 increase in the liability towards principal amount, only Rs. 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be Rs. 49,500 being the aggregate of interest of Rs. 24,000 on foreign currency borrowings (covered by paragraph 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. 25,500. Thus, Rs. 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining Rs. 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of Rs. 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings i.e., Rs. 34,500 (Rs. 58,500 - Rs. 24,000) is more than the exchange difference of Rs. 30,000. Therefore, in such a case, the total borrowing cost would be Rs. 54,000 (Rs. 24,000 + Rs. 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11.

Accounting Standards Interpretation (ASI) 12

Applicability of AS 20 Accounting Standard (AS) 20,

Earnings per Share Issue

[Pursuant to the issuance of this Accounting Standards Interpretation, General Clarification (GC) – 1/2002, issued in March 2002 stands withdrawn.]

ISSUE

1. Whether companies which are required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20.

CONSENSUS

2. Every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

BASIS FOR CONCLUSIONS

3. AS 20, 'Earnings Per Share', has come into effect in respect of accounting periods commencing on or after 1-4-2001 and is mandatory in nature, from that date, in respect of enterprises whose equity shares or potential equity shares are listed on a recognised stock exchange in India. AS 20 does not mandate an enterprise, which has neither equity shares nor potential equity shares which are so listed, to calculate and disclose earnings per share, but, if that enterprise discloses earnings per share for complying with the requirements of any statute or otherwise, it should calculate and disclose earnings per share in accordance with AS 20.

4. Part IV of Schedule VI to the Companies Act, 1956, requires, among other things, disclosure of earnings per share. Accordingly, every company, which is required to give information under Part IV of Schedule VI to the Companies Act, 1956, should calculate and disclose earnings per share in accordance with AS 20, whether or not its equity shares or potential equity shares are listed on a recognised stock exchange in India.

Accounting Standards Interpretation (ASI) 30

Applicability of AS 29 to Onerous Contracts

Accounting Standard (AS) 29, Provisions, Contingent Liabilities and Contingent Assets

ISSUE

1. An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The issue is how the recognition and measurement principles of AS 29 should be applied to the 'onerous contracts' covered within its scope.

CONSENSUS

2. If an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision as per AS 29.

3. For a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

4. The amount of provision in respect of an onerous contract should be measured by applying the principles laid down in AS 29. Accordingly, the amount of the provision should not be discounted to its present value.

The Appendix to this Interpretation illustrates the application of the above requirements.

BASIS FOR CONCLUSIONS

5. Paragraph 14 of AS 29 provides as follows:

"14. A provision should be recognized when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognized."

Many contracts (for example, some routine purchase orders) can be cancelled without paying compensation to the other party, and therefore, there is no obligation. Other contracts established both rights and obligations for each of the contracting parties. Where events make such a contract onerous, a liability exists, which is recognized.

In respect of such contracts the past obligating event is the signing of the contract, which gives rise to the present obligation. Besides this, when such a contract becomes onerous, an outflow of resources embodying economic benefits is probable.

6. Recognition of losses with regard to onerous contracts relating to items of inventory are recognized, under AS 2, Valuation of Inventories, by virtue of the consideration of the net realizable value. Further, the recognition of losses in case of onerous construction contracts is dealt with in AS 7, Construction Contracts. Therefore, it is inappropriate if in case of onerous contracts to which AS 29 is applicable, the provision is not recognized.

Appendix

Note: This appendix is illustrative only and does not form part of the Accounting Standards Interpretation. The purpose of this appendix is to illustrate the application of the Interpretation to assist in clarifying its meaning.

An enterprise operates profitably from a factory that it has leased under an operating lease. During December, 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it cannot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event – When obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – When the lease becomes onerous, an outflow of resources embodying economic benefits is probable. (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion – A provision is recognized for the best estimate of the unavoidable lease payments.