



**PROFESSIONAL COMPETENCE COURSE**

**STUDY MATERIAL**

**ADVANCED ACCOUNTING**

**VOLUME : 1**

# PAPER 1

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## ADVANCED ACCOUNTING



BOARD OF STUDIES  
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This study material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. Students should also supplement their study by reference to the recommended text books. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

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Website : [www.icai.org](http://www.icai.org)

E-mail : [bosnoida@icai.org](mailto:bosnoida@icai.org)

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## PREFACE

The paper of Advanced Accounting in the Professional Competence Course 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 twelve chapters, each addressing to a special aspect of accounting. Chapter 1 is based on conceptual framework for preparation and presentation of financial statements while chapter 2 deals with Accounting Standards. Chapters 3 to 6 cover company accounts including preparation of financial statements of banking, insurance and electricity companies. Chapter 7 lays emphasis on average due date, account current and self balancing ledgers whereas Chapter 8 deals with preparation of financial statements of not-for-profit organizations. Chapter 9 and 10 are devoted to accounting from incomplete records and accounting for special transactions i.e. hire purchase and instalment sale, investment accounts, departmental and branch accounts and insurance claims for loss of stock and loss of profit. Chapter 11 discusses accounting of partnership firms and Chapter 12 explains basic concepts of accounting in computerized environment. 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 Professional Competence Examination.

This study material has been prepared by a team of experts comprising of CA Seema Gupta, Assistant Director, ICAI and CA. Shilpa Agrawal, Executive Officer, ICAI, CA Yash Arya, CA Prasun Rakshit, CA Alok Agarwal, CA Suvendu Chunder and Mr. Anjan Bhattacharyya.

# SYLLABUS

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## PAPER –1 : ADVANCED ACCOUNTING

*(One paper — Three hours – 100 Marks)*

**Level of Knowledge:** Working knowledge

**Objectives:**

- (a) To lay a theoretical foundation for the preparation and presentation of financial statements,
- (b) To gain working knowledge of the professional standards, principles and procedures of accounting and their application to different practical situations,
- (c) To gain the ability to solve simple problems and cases relating to company accounts including special type of corporate entities, partnership accounts and
- (d) To familiarize students with the fundamentals of computerized system of accounting.

**Contents**

- 1. **Conceptual Framework for Preparation and Presentation of Financial Statements**
- 2. **Accounting Standards**

An overview; standards setting process

Working knowledge of:

- AS 1 : Disclosure of Accounting Policies
- AS 2 : Valuation of Inventories
- AS 3 : Cash Flow Statements
- AS 4 : Contingencies and Events occurring after the Balance Sheet Date
- AS 5 : Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
- AS 6 : Depreciation Accounting
- AS 7 : Construction Contracts (Revised 2002)

- AS 9 : Revenue Recognition
- AS 10 : Accounting for Fixed Assets
- AS 11 : The Effects of Changes in Foreign Exchange Rates (Revised 2003)
- AS 12 : Accounting for Government Grants
- AS 13 : Accounting for Investments
- AS 14 : Accounting for Amalgamations
- AS 16 : Borrowing Costs
- AS 19 : Leases
- AS 20 : Earnings Per Share
- AS 26 : Intangible Assets
- AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

### **3. Company Accounts**

- (a) Preparation of financial statements – Profit and Loss Account, Balance Sheet and Cash Flow Statement
- (b) Profit (Loss) prior to incorporation
- (c) Alteration of share capital, Conversion of fully paid shares into stock and stock into shares, Accounting for bonus issue, Accounting for employee stock option plan, Buy back of securities, Equity shares with differential rights, Underwriting of shares and debentures, Redemption of debentures
- (d) Accounting for business acquisition, Amalgamation and reconstruction (excluding problems of amalgamation on inter-company holding)
- (e) Accounting involved in liquidation of companies, Statement of Affairs (including deficiency/surplus accounts) and liquidator's statement of account of the winding up.

### **4. Financial Statements of Banking, Insurance and Electricity Companies**

### **5. Average Due Date, Account Current, Self-Balancing Ledgers**

### **6. Financial Statements of Not-for-Profit Organisations**

### **7. Accounts from Incomplete Records**

### **8. Accounting for Special Transactions**

- (a) Hire purchase and instalment sale transactions
- (b) Investment accounts
- (c) Departmental and branch accounts including foreign branches
- (d) Insurance claims for loss of stock and loss of profit.

#### **9. Advanced Issues in Partnership Accounts**

Final accounts of partnership firms – Admission, retirement and death of a partner including treatment of goodwill; Dissolution of partnership firms including piecemeal distribution of assets; Amalgamation of partnership firms; Conversion into a company and Sale to a company.

#### **10. Accounting in Computerised Environment**

An overview of computerized accounting system – Salient features and significance, Concept of grouping of accounts, Codification of accounts, Maintaining the hierarchy of ledger, Accounting packages and consideration for their selection, Generating Accounting Reports.

**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.



# VOLUME 1

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# CHAPTER 1

## CONCEPTUAL FRAMEWORK FOR PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS

### Learning Objectives

After studying this chapter, 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.



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## Conceptual Framework for Preparation and Presentation of Financial Statements

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- (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



## Conceptual Framework for Preparation and Presentation of Financial Statements

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 31/03/04 is given below:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	<u>5,000</u>
	<u>1,30,000</u>		<u>1,30,000</u>

### Additional information

- 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 31/03/05 was Rs. 60,000.
- The trader's purchases and sales in 2004-05 amounted to Rs. 4 lakh and Rs. 4.5 lakh respectively.
- The cost and net realisable value of stock at the end of 31/03/05 were Rs. 32,000 and Rs. 40,000 respectively.
- Expenses for the year amounted to Rs. 14,900.
- Deferred cost is amortised equally over 4 years
- 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.
- Closing trade creditors is Rs. 12,000, which is likely to be settled at 5% discount.
- Balance of closing cash is Rs. 37,100.
- There is an early repayment penalty for the loan Rs. 2,500.



## Advanced Accounting

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 31/03/05

	<i>Case (i)</i>	<i>Case (ii)</i>		<i>Case (i)</i>	<i>Case (ii)</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
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	<u>19,600</u>	<u>22,200</u>			
	<u>4,82,000</u>	<u>4,90,600</u>		<u>4,82,000</u>	<u>4,90,600</u>

### Balance Sheet as at 31/03/05

<i>Liabilities</i>	<i>Case (i)</i>	<i>Case (ii)</i>	<i>Assets</i>	<i>Case (i)</i>	<i>Case (ii)</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
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	<u>37,100</u>	<u>37,100</u>
	<u>1,51,600</u>	<u>1,56,100</u>		<u>1,51,600</u>	<u>1,56,100</u>

### 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



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## Conceptual Framework for Preparation and Presentation of Financial Statements

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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



## Advanced Accounting

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Profit & Loss A/c							
			Rs.				Rs.
Period 1	To Purchase		2,000	Period 1	By Sale	60,000	
	To Net Profit		58,000				
			<u>60,000</u>			<u>60,000</u>	
Period 2	To Purchase		50,000	Period 2	By Sale	2,500	
					By Net Loss	47,500	
			<u>50,000</u>			<u>50,000</u>	

### 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				
			<u>62,500</u>			<u>62,500</u>	

### 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.





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## Conceptual Framework for Preparation and Presentation of Financial Statements

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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



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## Conceptual Framework for Preparation and Presentation of Financial Statements

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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 be 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. 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



## Advanced Accounting

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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:

	<u>Rs.</u>	<u>Rs.</u>
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.



## Conceptual Framework for Preparation and Presentation of Financial Statements

### 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.

- Introduced capital Rs. 20,000
- Earned income from investment Rs. 8,000
- 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:

<i>Transactions</i>	<i>Assets</i> <i>Rs. lakh</i>	<i>-</i>	<i>Liabilities</i> <i>Rs. lakh</i>	<i>=</i>	<i>Equity</i> <i>Rs. lakh</i>
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 incurrance 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:**

<i>Transactions</i>	<i>Assets</i> <i>Rs. lakh</i>	<i>–</i>	<i>Liabilities</i> <i>Rs. Lakh</i>	<i>=</i>	<i>Equity</i> <i>Rs. lakh</i>
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



## Conceptual Framework for Preparation and Presentation of Financial Statements

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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  $CE = OE + C + \text{Profit} - D$

Or  $\text{Profit} = CE - OE - C + D$

Or  $\text{Profit} = (CA - CL) - (OA - OL) - C + D$

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:

	<u>Rs.</u>	<u>Rs.</u>	
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





## Conceptual Framework for Preparation and Presentation of Financial Statements

**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 15<sup>th</sup> 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.

	<u>Rs.</u>	<u>Rs.</u>
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 of interest is R:

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

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

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

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

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

$$\text{Or Present value of Rs. 11,000 after 1 year} = 11,000 \times 0.909 = \text{Rs. } 10,000$$

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.



## Conceptual Framework for Preparation and Presentation of Financial Statements

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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.



## Conceptual Framework for Preparation and Presentation of Financial Statements

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### *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



## Advanced Accounting

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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

	<u>Rs.</u>	<u>Rs.</u>
Closing capital (At historical cost)		12,000
Less: Capital to be maintained		
Opening capital (At historical cost)	12,000	
Introduction (At historical cost)	<u>Nil</u>	<u>12,000</u>
Retained profit		<u>Nil</u>

Financial Capital Maintenance at current purchasing power

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

Physical Capital Maintenance

	<u>Rs.</u>	<u>Rs.</u>
Closing capital (At current cost)		12,000
Less: Capital to be maintained		
Opening capital (At current cost)	15,000	
Introduction (At current cost)	<u>Nil</u>	<u>15,000</u>
Retained profit		<u>(3,000)</u>

**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.



## Advanced Accounting

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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 an 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 unit you will be able to:

- ◆ Understand the concept of Accounting Standards.
- ◆ Grasp the objectives, benefits and limitations of Accounting Standards.
- ◆ Learn the standards setting process.
- ◆ Familiarize with the overview of Accounting Standards in India.
- ◆ 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 ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in the company's economic performance. Accounting Standards reduce the accounting alternatives in the preparation of financial statements within the bounds of rationality, thereby ensuring comparability of financial statements of different enterprises. Accounting Standards deal with the issues of (i) recognition of events and transactions in the financial statements, (ii) measurement of these transactions and events, (iii) presentation of these transactions and events in the financial statements in a manner that is meaningful and understandable to the reader, and (iv) the disclosure requirements which should be there to enable the public at large and the stakeholders and the potential investors in particular, to get an insight into what these financial statements are trying to reflect and thereby facilitating them to take prudent and informed business decisions.

Accounting Standards standardize diverse accounting policies with a view to eliminate, to the maximum possible extent, (i) the non-comparability of financial statements and thereby improving the reliability of financial statements, and (ii) to provide a set of standard accounting policies, valuation norms and disclosure requirements.



Before moving on to further discussion, let us examine a very simple case of a trader to see how many rational figures of profit accountants can be derived:

- (i) On 01/04/05, a trader purchased 10 units of certain articles @ Rs. 50 per unit.
- (ii) On 02/04/05, the trader purchased further 10 units of same article @ Rs. 70 per unit.
- (iii) On 03/04/05, the trader sold 6 units of the article @ Rs. 65 per unit on credit
- (iv) On 04/04/05, the trader sold 9 units of the article @ Rs. 65 per unit for cash

A few of the possible profit and stock figures are shown below:

- (a) Profit Rs. 125 (FIFO and accrual basis); Value of stock = Rs. 350 (5 units)
- (b) Profit Rs. 25 (LIFO and accrual basis); Value of stock = Rs. 250 (5 units)
- (c) Profit Rs. 75 (Weighted average and accrual basis); Value of stock = Rs. 300 (5 units)
- (d) Profit Rs. 135 (FIFO, and cash basis); Value of stock = Rs. 750 (11 units)
- (e) Loss Rs. 45 (LIFO and cash basis); Value of stock = Rs. 570 (5 units)
- (f) Profit Rs. 45 (Weighted average and cash basis); Value of stock = Rs. 660 (11 units)

If as many as six alternatives are possible in this simple case, the readers can well imagine the number of possible alternatives that may exist in real life and the extent of confusion that will ensue. The users of financial statements are sure to lose all faith in accounting data and hardly any commerce will be possible. It is however worth noting that standardisation cannot reduce the number possible alternatives to one, because more than one method must be permitted to suit the needs of particular trades and it is impractical to think of separate standardisation for each kind of trade. For example, when one stores liquid in single container, the use of FIFO is not rational.

In the given case, standardisation (compliance with Accounting Standards) reduces the possible figures of profit and stock to two as explained below.

- (a) AS 2, Valuation of Inventory does not permit LIFO;
- (b) AS 9, Revenue Recognition, requires recognition of revenue for sale transactions when (i) the risks and rewards of ownership is transferred from the seller to buyer and (ii) no significant uncertainty exists regarding the amount of the consideration that will be derived from the sale of the goods. Thus, revenue should ordinarily be recognised on accrual basis. The two possible figures of profit and stock are as given below:

Profit Rs. 125 (FIFO and accrual basis); Value of stock = Rs. 350 (5 units)

Profit Rs. 75 (Weighted average and accrual basis); Value of stock = Rs. 300 (5 units)



The standard policies are intended to reflect a consensus on accounting policies to be used in different identified area, e.g. inventory valuation, capitalisation of costs, depreciations and amortisations and so on. Since it is not possible to prescribe a single set of policies in any area to be appropriate for all enterprises for all time, it is not enough to comply with the standards and state that they have been followed; one must also disclose the accounting policies actually used in preparation of financial statements. (See AS 1, Disclosure of Accounting Policies). For example, an enterprise should disclose which of the permitted cost formula (FIFO, Weighted Average etc.) has actually been used for ascertaining inventory costs.

In addition to improving credibility of accounting data, standardisation of accounting procedures improves comparability of financial statements, both intra-enterprise and inter-enterprise. Such comparisons are very effective and most widely used tools for assessment of enterprise performances by users of financial statements for taking economic decisions, e.g. whether or not to invest, whether or not to lend and so on. The intra-enterprise comparison involves comparison of financial statements of same enterprise over number of years. The intra-enterprise comparison is possible if the enterprise uses same accounting policies every year in drawing up its financial statements. For this reason, AS 1 requires disclosure of changes in accounting policies. The inter-enterprise comparison involves comparison of financial statements of different enterprises for same accounting period. This is possible only when comparable enterprises use same accounting policies in preparation of respective financial statements. The disclosure of accounting policies allows a user to make appropriate adjustments while comparing the financial statements.

A third advantage of standardisation is reduction of scope for creative accounting. The creative accounting refers to twisting of accounting policies to produce financial statements favourable to a particular interest group. For example, it is possible to overstate profits and assets by capitalising revenue expenditure or to understate them by writing off a capital expenditure against revenue of current accounting period. Such practices can be curbed only by framing rules for capitalisation, particularly for the borderline cases where it is possible to have divergent views. The accounting standards do just that. (See AS 10, AS 16 and AS 26 for instances)

In brief, 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.



## 2. EVOLUTION OF ACCOUNTING STANDARDS

Formal standard setting has a longer history in the United States than in any other country. As early as in 1932-34, the American Institute of Accountants (now known as American Institute of Certified Public Accountants), collaborated with the New York Stock Exchange in the formulation of five 'rules or principles' of accounting to narrow down the variations in accounting policies, recommend disclosures for significant items, and suggest improvement in disclosures required by accounting standards keeping in view the company law and other regulatory requirements. In 1959, the American Institute of Certified Public Accountants (AICPA) established the Accounting Principles Board (APB) with the objective of carrying on research so as to provide a solid conceptual base for its opinions. APB was replaced by Financial Accounting Standards Board (FASB) in 1973. Accounting Standards Committee (ASC) was set up in United Kingdom to lay down 'standards' which could produce greater uniformity in financial accounting practices.

Prior to 1970s, very few academicians paid much attention to the standard setting process in accounting. However, it became clear that standard setting was a fascinating process that had intertwined with the economic self-interests of the affected parties. Currently, standard setting boards or committees are active in number of countries including the United States, United Kingdom, Australia, Canada, India etc. In the same direction, the International Accounting Standards Committee (now known as IASB), the London based group responsible for developing International Accounting Standards, was set up in June 1973. The IASC comprises the professional accountancy bodies of over 75 countries (including the Institute of Chartered Accountants of India).

## 3. STANDARDS SETTING PROCESS

The Institute of Chartered Accountants of India (ICAI), being a premier accounting body in the country, took upon itself the leadership role by constituting the Accounting Standards Board (ASB) in 1977. The ICAI has taken significant initiatives in the setting and issuing procedure of Accounting Standards to ensure that the standard-setting process is fully consultative and transparent. The ASB considers the International Accounting Standards (IASs)/International Financial Reporting Standards (IFRSs) while framing Indian Accounting Standards (ASs) and try to integrate them, in the light of the applicable laws, customs, usages and business environment in the country. The composition of ASB includes, representatives of industries (namely, ASSOCHAM, CII, FICCI), regulators, academicians, government departments etc. Although ASB is a body constituted by the Council of the ICAI, it (ASB) is independent in the formulation of accounting standards and Council of the ICAI is not empowered to make any



modifications in the draft accounting standards formulated by ASB without consulting with the ASB.

The standard-setting procedure of ASB can be briefly outlined as follows:

- ◆ Identification of broad areas by ASB for formulation of AS.
- ◆ Constitution of study groups by ASB to consider specific projects and to prepare preliminary drafts of the proposed accounting standards. The draft normally includes objective and scope of the standard, definitions of the terms used in the standard, recognition and measurement principles wherever applicable and presentation and disclosure requirements.
- ◆ Consideration of the preliminary draft prepared by the study group of ASB and revision, if any, of the draft on the basis of deliberations.
- ◆ Circulation of draft of accounting standard (after revision by ASB) to the Council members of the ICAI and specified outside bodies such as Department of Company Affairs (DCA), Securities and Exchange Board of India (SEBI), Comptroller and Auditor General of India (C&AG), Central Board of Direct Taxes (CBDT), Standing Conference of Public Enterprises (SCOPE), etc. for comments.
- ◆ Meeting with the representatives of the specified outside bodies to ascertain their views on the draft of the proposed accounting standard.
- ◆ Finalisation of the exposure draft of the proposed accounting standard and its issuance inviting public comments.
- ◆ Consideration of comments received on the exposure draft and finalisation of the draft accounting standard by the ASB for submission to the Council of the ICAI for its consideration and approval for issuance.
- ◆ Consideration of the final draft of the proposed standard and by the Council of the ICAI, and if found necessary, modification of the draft in consultation with the ASB is done.

The accounting standard on the relevant subject is then issued by the ICAI.

#### **4. BENEFITS AND LIMITATIONS**

Accounting standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. By setting the accounting standards the accountant has following benefits:



- (i) Standards reduce to a reasonable extent or eliminate altogether confusing variations in the accounting treatments used to prepare financial statements.
- (ii) There are certain areas where important information are not statutorily required to be disclosed. Standards may call for disclosure beyond that required by law.
- (iii) The application of accounting standards would, to a limited extent, facilitate comparison of financial statements of companies situated in different parts of the world and also of different companies situated in the same country. However, it should be noted in this respect that differences in the institutions, traditions and legal systems from one country to another give rise to differences in accounting standards adopted in different countries.

However, there are some limitations of setting of accounting standards:

- (i) Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- (ii) There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- (ii) Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

## 5. HOW MANY AS ?

The council of the Institute of Chartered Accountants of India has, so far, issued twenty nine Accounting Standards. However, AS 8 on 'Accounting for Research and Development' has been withdrawn consequent to the issuance of AS 26 on 'Intangible Assets'. Thus effectively, there are 28 Accounting Standards at present. The 'Accounting Standards' issued by the Accounting Standards Board establish standards which have to be complied by the business entities so that the financial statements are prepared in accordance with generally accepted accounting principles.

## 6. APPLICABILITY OF ACCOUNTING STANDARDS

The standards are developed by the Accounting Standards Board (ASB) of the institute and are issued under the authority of its Council. The institute not being a legislative body can enforce compliance with its standards only by its members. Also, the standards cannot override laws and local regulations. The accounting standards are nevertheless made mandatory from the dates specified in respective standards and are generally applicable to all enterprises, subject to certain exception as stated below. The implication of mandatory status



of an accounting standard depends on whether the statute governing the enterprise concerned requires compliance with the standard.

In assessing whether an accounting standard is applicable, one must find correct answer to the following three questions.

- (a) Does it apply to the enterprise concerned? If yes, the next question is:
- (b) Does it apply to the financial statement concerned? If yes, the next question is:
- (c) Does it apply to the financial item concerned?

The preface to the statements of accounting standards answers the above questions.

Enterprises to which the accounting standards apply

Accounting Standards apply in respect of any enterprise (whether organised in corporate, co-operative or other forms) engaged in commercial, industrial or business activities, whether or not profit oriented and even if established for charitable or religious purposes. Accounting Standards however, do not apply to enterprises solely carrying on the activities, which are not of commercial, industrial or business nature, (e.g., an activity of collecting donations and giving them to flood affected people). Exclusion of an enterprise from the applicability of the Accounting Standards would be permissible only if no part of the activity of such enterprise is commercial, industrial or business in nature. Even if a very small proportion of the activities of an enterprise were considered to be commercial, industrial or business in nature, the Accounting Standards would apply to all its activities including those, which are not commercial, industrial or business in nature.

Implication of mandatory status

Where the statute governing the enterprise does not require compliance with the accounting standards, e.g. a partnership firm, the mandatory status of an accounting standard implies that, in discharging their attest functions, the members of the Institute are required to examine whether the financial statements are prepared in compliance with the applicable accounting standards. (See Scheme of Applicability) In the event of any deviation from the accounting standards, they have the duty to make adequate disclosures in their reports so that the users of financial statements may be aware of such deviations. It should nevertheless be noted that responsibility for the preparation of financial statements and for making adequate disclosure is that of the management of the enterprise. The auditor's responsibility is to form his opinion and report on such financial statements.

Where the statute governing the enterprise requires compliance with the accounting standards, e.g. companies, mandatory status of an accounting standard implies that the duty of compliance is primarily on the enterprise presenting the financial statement.



Section 211(3A) of the Companies Act requires companies to present their profit and loss accounts and balance sheets in compliance with the accounting standards. (See Note 1) Also, the auditor is required by section 227(3)(d) to report whether, in his opinion, the profit and loss account and balance sheet of the company audited, comply with the accounting standards referred to in section 211(3C). Where the profit and loss account and balance sheet of a company do not comply with the accounting standards, the company is required by section 211(3B) to disclose the deviations from the accounting standards together with reasons for the deviations and financial effect if any arising due to such deviations.

In addition, listed companies are required to comply with the accounting standards issued by The Institute of Chartered Accountants of India, by clause 50 of listing agreement with the stock exchanges.

The above discussion shows that unlike other enterprises, duty to comply with the standards is also on the company, which is presenting the financial statements.

Note 1:

As per section 211(3C), the expression 'accounting standards', for the purpose of section 211(3A), means standards of accounting recommended by the Institute of Chartered Accountants of India, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under subsection (1) of section 210A. It is also provided that, till the time the Central Government prescribes accounting standards, the accounting standards specified by the Institute of Chartered Accountants of India shall be deemed to be accounting standards for the purpose of section 211(3A). Till date, the Central Government has not prescribed any accounting standards. For the purpose of section 211(3A) and Section 227(3)(d), the institute has specified all mandatory accounting standards. In other words, companies are required to comply with all applicable mandatory standards issued by the Institute of Chartered Accountants of India.

Note 2

Enterprises in insurance business are required to comply with the accounting standards by the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000. The standards to be complied by these enterprises are those, made applicable to them.

Financial items to which the accounting standards apply

The Accounting Standards are intended to apply only to items, which are material. An item is considered material, if its omission or misstatement is likely to affect economic decision of the user. Materiality is not necessarily a function of size; it is the information content of the financial item which is important. A penalty of Rs. 50,000 paid for breach of law by a company can seem to be a relatively small amount for a company incurring crores of rupees in a year,





yet is a material item because of the information it conveys. The materiality should therefore be judged on case-to-case basis. If an item is material, it should be shown separately instead of clubbing it with other items. For example it is not appropriate to club the penalties paid with legal charges.

Conflict between requirements of accounting standard and Court/Tribunal order

On 17 November 2004, the Council of the ICAI has announced that if an item in the financial statement of an enterprise is treated differently pursuant to an Order made by the Court/Tribunal, as compared to the treatment required by an Accounting Standard, following disclosures should be made in the financial statements of the year in which different treatment has been given:

A description of the accounting treatment made along with the reason that the same has been adopted because of the Court/Tribunal Order.

- (a) Description of the difference between the accounting treatment prescribed in the Accounting Standard and that followed by the enterprise.
- (b) The financial impact, if any, arising due to such a difference.

Accounting Standard and Income Tax Act

Accounting standards intend to reduce diversity in application of accounting principles. They improve comparability of financial statements and promote transparency and fairness in their presentation. Deductions and exemptions allowed in computation of taxable income on the other hand, is a matter fiscal policy of the government. Thus, an expense required to be charged against revenue by an accounting standard does not imply that the same is always deductible for income tax purposes. For example, depreciation on assets taken on finance lease is charged in the books of lessee as per AS 19 but depreciation for tax purpose is allowed to lessor, being legal owner of the asset, rather than to lessee. Likewise, recognition of a revenue in the financial statements cannot be avoided simply because it is exempted under section 10 of Income Tax Act.

As already explained, the Guidance Note on Audit Under Section 44AB of Income Tax Act, requires all financial statements prepared under mercantile system of accounting to comply with all applicable mandatory accounting standards issued by the Institute. The financial statements prepared under cash basis of accounting however, need not adhere to the accounting standards issued by the Institute.

It follows from above, that a member of the Institute reporting for tax audit purposes, is under an obligation to see whether the audited financial statements, if prepared under mercantile system of accounting, comply with all applicable mandatory standards issued by the Institute. In case of any deviation, the member should consider making qualification/appropriate disclosure in his reports.



It should be noted that the Central Government has notified two accounting standards, viz. AS (IT) 1, Disclosure of Accounting Policies and AS (IT) 2, Disclosure of Prior Period and Extra Ordinary Items and Disclosure of Accounting Policies for the purpose of taxation. Section 145 of Income Tax Act requires all assesses keeping their books by the mercantile system of accounting to comply with these two standards. Also, requirements of AS (IT) 1 and AS (IT) 2 are practically same as the corresponding AS 1 and AS 5 issued by the institute. The mandatory compliance of AS (IT) 1 and AS (IT) 2 are nevertheless required for the limited purpose of income tax.

Mandatory accounting standards issued by the ICAI apply to all financial statements prepared under mercantile system irrespective of the requirements of Income Tax Act. The differences between requirements of Income Tax Act and those of accounting standards cause taxable profit to differ from the accounting profit before tax.

## 7. ACCOUNTING STANDARD INTERPRETATIONS

The Accounting Standard Interpretations address questions that arise in course of application of a standard. These are therefore issued after issue of the relevant standard. Authority of an interpretation is same as that of the Accounting Standard to which it relates. So far, 30 interpretations have been issued.

A brief summary of these interpretations is given below. The readers may refer appropriate chapters for details.

No.	Related AS	Topic
1	16	Interpretation of the term 'substantial period'
2	2, 10	Treatment of machinery spares
3	22	Computation of deferred tax during tax holiday u/s 80-IA and 80-IB (Revised)
4	22	Computation of deferred tax in respect of losses under the head Capital Gains
5	22	Computation of deferred tax during tax holiday u/s 10A and 10B
6	22	Computation of current and deferred tax subject to MAT u/s 115JB
7	22	Disclosure of deferred tax assets/liabilities in balance sheet
8	21, 23, 27	Interpretation of the term 'near future'
9	22	Interpretation of the term 'virtual certainty'
10	16	Computation of exchange difference to be treated as borrowing cost
11	22	Computation of deferred tax in case of Amalgamations
12	20	Applicability of AS 20 to unlisted companies
13	18	Aggregation of related party disclosures



14	9	Manner of disclosure of excise duty
15	21	Notes to the Consolidated Financial Statements (CFS)
16	23	Treatment in CFS: Dividend proposed by an associate
17	23	Treatment in CFS: Changes in equity not included in P & L A/c
18	23	Consideration of potential equity to ascertain whether the investee is an associate
19	18	Interpretation of the term 'intermediary'
20	17	Disclosure of segment information in certain cases (Revised)
21	18	Non-executive directors; whether related parties
22	17	Interest expenses; whether to treat as segment expenses
23	18	Remuneration paid to key management personnel; whether related party transaction
24	21	Subsidiaries having two parents
25	21	Shares held as stock-in-trade
26	21	Consolidation of current and deferred tax
27	25	Applicability of AS 25
28	21, 27	Disclosure of post-acquisition reserves in Consolidated Financial Statements
29	7	Turnover in case of contractors
30	29	Applicability of AS 29 to onerous contracts

## 8. COMPLIANCE OF ACCOUNTING STANDARDS

For the purpose of compliance of the Accounting Standards, all enterprises in India are classified into three broad categories:

*Level I Enterprise:* Following enterprises are covered under this level:

- ◆ Enterprises, whose equity or debt securities are either listed or is in the process to be listed in India or outside India.
- ◆ Banks, Insurance Companies and Financial Institutions.
- ◆ All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year is in excess of Rs. 50 crores (as per the audited financial statement).
- ◆ All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year are in excess of Rs. 10 crores (as per the audited financial statement).



- ◆ Holding or subsidiary company of any of the above enterprises any time during the year.

*Level II Enterprise:* Following enterprises are covered under this level:

- ◆ All commercial, industrial and other reporting business enterprises, whose total turnover during the previous year exceeds Rs. 40 lakhs but within the limit of Rs. 50 crores (as per the audited financial statement).
- ◆ All commercial, industrial and other reporting business enterprises, whose total borrowings including public deposits during the previous year exceeds Rs. 1 crore but within the limit of Rs. 10 crores (as per the audited financial statement).
- ◆ Holding or subsidiary company of any of the above enterprises any time during the year.

*Level III Enterprise:* All the enterprises not covered in above two levels come under this level.

Following is the list of Accounting Standards with their respective date of applicability along with the scope.

AS No.	AS Title	Date	Scope
1	Disclosure of Accounting Policies	01/04/1993	All Level
2	Valuation of Inventories (Revised)	01/04/1999	All Level
3	Cash Flow Statement (Revised)	01/04/2001	Level I
4	Contingencies and Events Occurring after the Balance Sheet Date	01/04/1998	All Level
5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (Revised)	01/04/1996	All Level
6	Depreciation Accounting (Revised)	01/04/1995	All Level
7	Construction Contracts (Revised)	01/04/2002	All Level
8	Research & Development	Now included	in AS – 26
9	Revenue Recognition	01/04/1993	All Level
10	Accounting for Fixed Assets	01/04/1993	All Level
11	The Effects of Changes in Foreign Exchange Rates (Revised)	01/04/2004	All Level
12	Accounting for Government Grants	01/04/1994	All Level



## Accounting Standards

13	Accounting for Investments	01/04/1995	All Level
14	Accounting for Amalgamations	01/04/1995	All Level
15	Employee Benefits	01/04/2006	All Level
16	Borrowing Costs	01/04/2000	All Level
17	Segment Reporting	01/04/2001	Level I
18	Related Party Disclosures	01/04/2001	Level I
19	Leases	01/04/2001	All Level
20	Earning Per Shares	01/04/2001	Level I
21	Consolidated Financial Statement	01/04/2001	Enterprises preparing CFS*
22	Accounting for Taxes on Income	01/04/2001	Listed Companies
		01/04/2002	Other Companies
		01/04/2006	All Enterprises
23	Accounting for Investment in Associates in Consolidated Financial Statement	01/04/2002	Enterprises preparing CFS
24	Discontinuing Operations	01/04/2004	Level I
25	Interim Financial Statement	01/04/2002	Level I
26	Intangible Assets	01/04/2003	All Level
27	Financial Reporting of Interests in Joint Ventures	01/04/2002	Enterprises preparing CFS
28	Impairment of Assets	01/04/2004	Level I
		01/04/2006	Level II
		01/04/2008	Level III
29	Provisions, Contingent Liabilities and Contingent Assets	01/04/2004	All Level

\* CFS has been written for cash flow statement.



*Note: Accounting Standards 1, 2, 3, 4, 5, 6, 7, 9, 10, 11, 12, 13, 14, 16, 19, 20, 26, 29 are covered in the PCE syllabus and have been discussed in detail in the next para.*

## 9. OVERVIEW

### 9.1 DISCLOSURE OF ACCOUNTING POLICIES (AS 1)

Irrespective of extent of standardisation, diversity in accounting policies is unavoidable for two reasons. First, accounting standards cannot and do not cover all possible areas of accounting and enterprises have the freedom of adopting any reasonable accounting policy in areas not covered by a standard. Second, since enterprises operate in diverse situations, it is impossible to develop a single set of policies applicable to all enterprises for all time. The accounting standards therefore permit more than one policy even in areas covered by it. Differences in accounting policies lead to differences in reported information even if underlying transactions are same. The qualitative characteristic of comparability of financial statements therefore suffers due to diversity of accounting policies. Since uniformity is impossible, and accounting standards permit more than one alternative in many cases, it is not enough to say that all standards have been complied with. For these reasons, accounting standard 1 requires enterprises to disclose accounting policies actually adopted by them in preparation of their financial statements. Such disclosures allow the users of financial statements to take the differences in accounting policies into consideration and to make necessary adjustments in their analysis of such statements.

The purpose of Accounting Standard 1, Disclosure of Accounting Policies, is to promote better understanding of financial statements by requiring disclosure of significant accounting policies in orderly manner. As explained in the preceding paragraph, such disclosures facilitate more meaningful comparison between financial statements of different enterprises for same accounting periods. The standard also requires disclosure of changes in accounting policies such that the users can compare financial statements of same enterprise for different accounting periods.

Accounting Standard 1, Disclosure of Accounting Policies, was first issued November 1979. It came into effect in respect of accounting periods commencing on or after April 1, 1991. The standard applies to all enterprises.

#### *Fundamental Accounting Assumptions (Paragraph 10)*

The Accounting Standard 1 recognises three fundamental accounting assumptions. These are (a) Going Concern (b) Consistency and (c) Accrual. So long as these assumptions are followed in preparation of financial statements, no disclosure of such adherence is necessary. Any departure from any of these assumptions should however be disclosed. Details of these assumptions have been discussed in the chapter 1 on 'Conceptual Framework for the Preparation and Presentation of Financial Statements', hence are not repeated here.



*Selection of Accounting Policy (Paragraph 17)*

Financial Statements are prepared to portray a true and fair view of the performance and state of affairs of an enterprise. In selecting a policy, alternative accounting policies should be evaluated in that light. In particular, major considerations that govern selection of a particular policy are:

**Prudence**

In view of uncertainty associated with future events, profits are not anticipated, but losses are provided for as a matter of conservatism. Provision should be created for all known liabilities and losses even though the amount cannot be determined with certainty and represents only a best estimate in the light of available information. The exercise of prudence in selection of accounting policies ensure that (i) profits are not overstated (ii) losses are not understated (iii) assets are not overstated and (iv) liabilities are not understated. The prudence however does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses.

Example

The most common example of exercise of prudence in selection of accounting policy is the policy of valuing inventory at lower of cost and net realisable value.

Suppose a trader has purchased 500 units of certain article @ Rs. 10 per unit. He sold 400 articles @ Rs. 15 per unit. If the net realisable value per unit of the unsold article is Rs. 15, the trader shall value his stock at Rs. 10 per unit and thus ignoring the profit Rs. 500 that he may earn in next accounting period by selling 100 units of unsold articles. If the net realisable value per unit of the unsold article is Rs. 8, the trader shall value his stock at Rs. 8 per unit and thus recognising possible loss Rs. 200 that he may incur in next accounting period by selling 100 units of unsold articles.

Profit of the trader if net realisable value of unsold article is Rs. 15

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times \text{Rs. } 15) - (500 \times \text{Rs. } 10 - 100 \times \text{Rs. } 10) = \text{Rs. } 2,000$$

Profit of the trader if net realisable value of unsold article is Rs. 8

$$= \text{Sale} - \text{Cost of goods sold} = (400 \times \text{Rs. } 15) - (500 \times \text{Rs. } 10 - 100 \times \text{Rs. } 8) = \text{Rs. } 1,800$$

Example

Exercise of prudence does not permit creation of hidden reserve by understating profits and assets or by overstating liabilities and losses. Suppose a company is facing a damage suit. No provision for damages should be recognised by a charge against profit, unless the probability of losing the suit is more than the probability of not losing it.

Substance over form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.



### Materiality

Financial statements should disclose all 'material items, i.e. the items the knowledge of which might influence the decisions of the user of the financial statement. Materiality is not always a matter of relative size. For example a small amount lost by fraudulent practices of certain employees can indicate a serious flaw in the enterprise's internal control system requiring immediate attention to avoid greater losses in future. In certain cases quantitative limits of materiality is specified. A few of such cases are given below:

(a) In giving break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of purchases, stocks or turnover as the case may be, are shown as separate and distinct items with quantities thereof in the break-up. (Requirements as to Profit & Loss Account; Part II of Schedule VI of Companies Act).

(b) Any item under which the expenses exceed 1 per cent of total revenue of the company or Rs. 5,000, whichever is higher, are shown as a separate and distinct item against appropriate account head in the Profit & Loss Account and are not combined with any other item shown under 'Miscellaneous Expenses'. (Requirements as to Profit & Loss Account; Part II of Schedule VI of Companies Act).

### Manner of disclosure

(c) All significant accounting policies adopted in the preparation and presentation of financial statements should be disclosed (Paragraph 24)

(d) The disclosure of the significant accounting policies as such should form part of the financial statements and the significant accounting policies should normally be disclosed in one place. (Paragraph 25)

### Note:

Being a part of the financial statement, the opinion of auditors shall cover the disclosures of accounting policies. In view of paragraph 25, it is not appropriate to scatter the disclosures of accounting policies over the financial statement. For example, it is not correct to disclose depreciation policy as part of schedule of fixed assets and inventory policy as part of schedule of inventory.

### Disclosure of Changes in Accounting Policies (Paragraph 26)

Any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in a later period should be disclosed. In the case of a change in accounting policies, which has a material effect in the current period, the amount by which any item in the financial statements is affected by such change should





also be disclosed to the extent ascertainable. Where such amount is not ascertainable, wholly or in part, the fact should be indicated.

### Examples

1 A simple disclosure that an accounting policy has been changed is not of much use for a reader of a financial statement. The effect of change should therefore be disclosed wherever ascertainable. Suppose a company has switched over to weighted average formula for ascertaining cost of inventory, from the earlier practice of using FIFO. If the closing inventory by FIFO is Rs. 2 lakh and that by weighted average formula is Rs. 1.8 lakh, the change in accounting policy pulls down profit and value of inventory by Rs. 20,000. The company may disclose the change in accounting policy in the following manner:

'The company values its inventory at lower of cost and net realisable value. Since net realisable value of all items of inventory in the current year was greater than respective costs, the company valued its inventory at cost. In the present year the company has changed to weighted average formula, which better reflects the consumption pattern of inventory, for ascertaining inventory costs from the earlier practice of using FIFO for the purpose. The change in policy has reduced profit and value of inventory by Rs. 20,000'.

2. A change in accounting policy is to be disclosed if the change is reasonably expected to have material effect in future accounting periods, even if the change has no material effect in the current accounting period.

The above requirement ensures that all important changes in accounting policies are actually disclosed. Suppose a company makes provision for warranty claims based on estimated costs of materials and labour. The company changed the policy in 2003-04 to include overheads in estimating costs for servicing warranty claims. If value of warranty sales in 2003-04 is not significant, the change in policy will not have any material effect on financial statements of 2003-04. Yet, the company must disclose the change in accounting policy in 2003-04 because the change can affect future accounting periods when value of warranty sales may rise to a significant level. If the disclosure is not made in 2003-04, no disclosure in future years will be necessary because an enterprise is required to disclose changes in accounting policies in the year of change only.

### Disclosure of deviations from fundamental accounting assumptions (Paragraph 27)

If the fundamental accounting assumptions, viz. Going concern, Consistency and Accrual are followed in financial statements, specific disclosure is not required. If a fundamental accounting assumption is not followed, the fact should be disclosed.

The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The deviation from the principle of consistency



therefore means a change in accounting policy, the disclosure requirements for which are covered by paragraph 26.

## 9.2 VALUATION OF INVENTORY (AS 2)

The cost of closing inventory, e.g. cost of closing stock of raw materials, closing work-in-progress and closing finished stock, is a part of costs incurred in the current accounting period that is carried over to next accounting period. Likewise, the cost of opening inventory is a part of costs incurred in the previous accounting period that is brought forward to current accounting period. Since inventories are assets, and assets are resources expected to cause flow of future economic benefits to the enterprise, the costs to be included in inventory costs, are costs that are expected to generate future economic benefits to the enterprise. Such costs must be costs of acquisition and costs that change either (i) the location of the inventory, e.g. freight incurred to carry the materials to factory or (ii) conditions of the inventory, e.g. costs incurred to convert the materials into finished stock. The costs incurred to maintain the inventory, e.g. storage costs, do not generate any extra economic benefits for the enterprise and therefore should not be included in inventory costs.

The valuation of inventory is crucial because of its direct impact in measuring profit/loss for an accounting period. Higher the value of closing inventory lower is the cost of goods sold and hence larger is the profit. The principle of prudence demands that no profit should be anticipated while all foreseeable losses should be recognised. Thus, if net realisable value of inventory is less than inventory cost, inventory is valued at net realisable value to reduce the reported profit in anticipation of loss. On the other hand, if net realisable value of inventory is more than inventory cost, the anticipated profit is ignored and the inventory is valued at cost. In short, inventory is valued at lower of cost and net realisable value. The standard specifies (i) what the cost of inventory should consist of and (ii) how the net realisable value is determined.

Failure of an item of inventory to recover its costs is unusual. If net realisable value of an item of inventory is less than its cost, the fall in profit in consequence of writing down of inventory to net realisable is an unusual loss and should be shown as a separate line item in the Profit & Loss A/c to help the users of financial statements to make a more informed analysis of the enterprise performance. (See AS 5, for details)

By their very nature, abnormal gains or losses are not expected to recur regularly. For a meaningful analysis of an enterprise's performance, the users of financial statements need to know the amount of such gains/losses included in current profit/loss. For this reason, instead of taking abnormal gains and losses in inventory costs, these are shown in the Profit & Loss A/c in such way that their impact on current profit/loss can be perceived. (See AS 5 for details)

Parts I and II of Schedule VI of Companies Act prescribes valuation and disclosure norms for inventory held by companies. The AS 2, Valuation of Inventories was first issued in June 1981



to supplement the legal requirements. It was revised and made mandatory for all enterprises in respect of accounting periods commencing on or after April 1, 1999.

Paragraph 3 of the standard defines inventories as assets held

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

As per paragraph 1, the following are excluded from the scope of AS 2.

Work in progress arising under construction contracts, i.e. cost of part construction, including directly related service contracts, being covered under AS 7, Accounting for Construction Contracts; Inventory held for use in construction, e.g. cement lying at the site shall however be covered by AS 2.

- (a) Work in progress arising in the ordinary course of business of service providers i.e. cost of providing a part of service. For example, for a shipping company, fuel and stores not consumed at the end of accounting period is inventory but not costs for voyage-in-progress. Work-in-progress may arise for different other services e.g. software development, consultancy, medical services, merchant banking and so on.
- (b) Shares, debentures and other financial instruments held as stock-in-trade. It should be noted that these are excluded from the scope of AS 13 as well. The current Indian practice is however to value them at lower of cost and fair value.
- (c) Producers' inventories of livestock, agricultural and forest products, and mineral oils, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries, e.g. where sale is assured under a forward contract or a government guarantee or where a homogenous market exists and there is negligible risk of failure to sell.

#### Machinery spares (Accounting Standard Interpretation 2)

Machinery spares, which are not specific to a particular item of fixed asset but can be used generally for various items of fixed assets, should be treated as inventories for the purpose of AS 2. Such machinery spares should be charged to the statement of profit and loss as and when issued for consumption in the ordinary course of operations. Other types of machinery spares are treated as fixed assets (See AS 10, for details).

Containers and Empties



Containers and empties are not goods for sale the ordinary course of business, nor are they goods in the production process nor they are materials or supplies for consumption in the production process or in rendering of services. The Expert Advisory Committee of ICAI has however expressed an opinion that containers and empties are items of inventory. It seems nevertheless that containers and empties having useful life more than one year should be regarded as depreciable assets, in accordance with AS 6.

Measurement of Inventories (Paragraph 5)

Inventories should be valued at lower of cost and net realisable value. As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. The valuation of inventory at lower of cost and net realisable value is based on the view that no asset should be carried at a value which is in excess of the value realisable by its sale or use.

*Example 1*

Cost of a partly finished unit at the end of 2004-05 is Rs. 800. The unit can be finished next year by a further expenditure of Rs. 100. The finished unit can be sold Rs. 250, subject to payment of 4% brokerage on selling price. The value of inventory is determined below:

	Rs.
Net selling price	<u>250</u>
Less: Estimated cost of completion	<u>100</u>
	150
Less: Brokerage (4% of 250)	<u>10</u>
Net Realisable Value	<u>140</u>
Cost of inventory	<u>800</u>
Value of inventory (Lower of cost and net realisable value)	140

Note:

Incremental cost Rs. 100 (cost to complete) is less than incremental revenue Rs. 240 (Rs. 250 – Rs. 10). The enterprise will therefore decide to finish the unit for sale at Rs. 250.

*Example 2*

In example 1, suppose cost to complete the unit is Rs. 245 instead of Rs. 100. The enterprise will be better off by not finishing the unit as shown below:

Incremental cost Rs. 245 (cost to complete) is more than incremental revenue Rs. 240 (Rs. 250 – Rs. 10). The enterprise will therefore prefer not to finish the unit.



Net Realisable Value = Nil

Cost = Rs. 800

Value of inventory (Lower of cost and net realisable value) = Nil

Costs of inventory (Paragraph 6)

*Costs of inventories comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.*

Costs of purchase (Paragraph 7)

The costs of purchase consist of the purchase price including duties and taxes (other than those subsequently recoverable by the enterprise from the taxing authorities, e.g. CENVAT credit, State level Value Added Tax etc, freight inwards and other expenditure directly attributable to the acquisition. Trade discounts, rebates, duty drawbacks and other similar items are deducted in determining the costs of purchase.

*Example 3*

An enterprise ordered 13,000 Kg. of certain material at Rs. 90 per unit. The purchase price includes excise duty Rs. 5 per Kg., in respect of which full CENVAT credit is admissible. Freight incurred amounted to Rs. 80,600. Normal transit loss is 4%. The enterprise actually received 12,400 Kg and consumed 10,000 Kg.

Cost of inventory and allocation of material cost is shown below.

Normal cost per Kg.

	Rs.
Purchase price (13,000 Kg. x Rs. 90)	11,70,000
Less: CENVAT Credit (13,000 Kg. x Rs. 5)	65,000
	11,05,000
Add: Freight	80,600
A. Total material cost	11,85,600
B. Number units normally received = 96% of 13,000 Kg.	Kg. 12,480
C. Normal cost per Kg. (A/B)	95

Allocation of material cost

	Kg.	Rs./Kg.	Rs.
Materials consumed	10,000	95	9,50,000



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Cost of inventory	2,400	95	2,28,000
Abnormal loss	80	95	7,600
Total material cost	<u>12,480</u>	95	<u>11,85,600</u>

Note: Abnormal losses are recognised as separate expense

#### Costs of Conversion

The costs of conversion include costs directly related to production, e.g. direct labour. They also include overheads, both fixed and variable. (Paragraph 8)

The fixed production overheads should be absorbed systematically to units of production over normal capacity. Normal capacity is the production the enterprise expects achieve on an average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates the normal capacity. (Paragraph 9)

The amount of fixed production overheads allocated to each unit of production should not be increased as a consequence of low production or idle plant. Unallocated overheads (i.e. under recovery) is recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed production overheads allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are assigned to each unit of production on the basis of the actual use of the production facilities. (Paragraph 9)

*The above two points imply:*

Where actual production is less than or equal to normal capacity, fixed overheads are recovered on the basis of normal capacity.

Where actual production is more than normal capacity, fixed overheads are recovered on the basis of actual production.

#### Example 4

In example 3, suppose normal processing loss is 5% of input. During the accounting period, the enterprise has actually produced 9,600 units of finished product. 9,300 units were sold at Rs. 250 per unit. The labour and overhead costs amounted to Rs. 6,12,845 and Rs. 2,23,440 respectively. Overheads are recovered on the basis of output. Excise duty on final product is Rs. 28.50 per unit

Profit & Loss A/c and costs of finished inventory assuming (i) normal capacity is 9,400 units (ii) normal capacity is 9,800 units are shown below.

Case (i) (Actual production 9,600 units is more than normal capacity 9,400 units)

Normal recovery rate = Rs. 2,23,440 / 9,400 units = Rs. 23.77



Actual Overhead per unit = Rs. 2,23,440 / 9,600 units = Rs. 23.275

Recovery rate is decreased to actual Rs. 23.275 per unit due to high production.

Normal cost per unit of finished product

	Rs.
Materials consumed	9,50,000
Wages	6,12,845
Overheads (9,600 x Rs. 23.275)	2,23,440
Excise Duty (9,600 x Rs. 28.50)	2,73,600
A. Total cost	20,59,885
B. Normal output (95% of 10,000)	9,500 units
C. Normal cost per unit of finished product (A/B)	216.83

Allocation of total cost

	Units	Rs./Unit	Rs.
Cost of goods sold	9,300	216.83	20,16,519
Cost of finished inventory	300	216.83	65,049
	9,600	216.83	20,81,568
Less: Abnormal gain	100	216.83	21,683
Total cost	9,500	216.83	20,59,885

Statement of Profit & Loss

	Rs.	Rs.
Sales		23,25,000
Less: Cost of goods sold		20,16,519
		3,08,481
Abnormal Gain	21,683	
Less: Abnormal loss	7,600	14,083
Net profit		3,22,564

Case (ii) (Actual production 9,600 units is less than normal capacity 9,800 units)

Normal Overhead recovery rate = Rs. 2,23,440 / 9,800 units = Rs. 22.80



## Advanced Accounting

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Actual overhead per unit = Rs. 2,23,440 / 9,600 units = Rs. 23.275

Recovery rate is not increased to actual Rs. 23.275 per unit due to low production.

Overhead recovered = 9,600 x Rs. 22.80 = Rs. 2,18,880

Under-recovery = Rs. 2,23,440 – Rs. 2,18,880 = Rs. 4,560

Under recovery per unit of normal output = Rs. 4,560 / 9,500 = Re. 0.48

Normal cost per unit of finished product

	Rs.
Materials consumed	<u>9,50,000</u>
Wages	6,12,845
Overheads (9,600 x Rs. 22.80)	2,18,880
Excise Duty (9,600 x Rs. 28.50)	<u>2,73,600</u>
A. Total cost	<u>20,55,325</u>
B. Normal output (95% of 10,000)	<u>9,500 units</u>
C. Normal cost per unit of finished product (A/B)	216.35

Allocation of total cost

	Units	Rs./Unit	Rs.
Cost of goods sold	<u>9,300</u>	216.35	<u>20,12,055</u>
Cost of finished inventory	300	216.35	64,905
	<u>9,600</u>	216.35	<u>20,76,960</u>
Less: Abnormal gain	100	216.35	21,635
	<u>9,500</u>	216.35	<u>20,55,325</u>
Add: Under-recovery			4,560
Total cost			<u>20,59,885</u>

Statement of Profit & Loss

	Rs.	Rs.
Sales	<u>                    </u>	<u>23,25,000</u>





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Accounting Standards

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Less: Cost of goods sold		20,12,055
		<hr/> 3,12,945
Less: Under recovery		4,560
		<hr/> 3,08,385
Abnormal Gain	21,635	
Less: Abnormal loss	7,600	14,035
Net profit		<hr/> 3,22,420

Note 1

Excise duty on output is product cost rather than period cost. Hence taken in production cost and consequently in cost of inventory.

Note 2

Profit in case (ii) is reduced by Rs. 144 from that in case (i). This is because, the whole of under recovery is charged against profit for the year in case (ii) while a part of current year overhead Rs. 144 (300 units x Re. 0.48 per unit) gets carried over to next period as part of inventory cost in case (i).

Joint or by Products (Paragraph 10)

In case of joint or by products, the costs incurred up to the stage of split off should be allocated on a rational and consistent basis. The basis of allocation may be sale value at split off point, for example. The value of by products, scrap and wastes are usually not material. These are therefore at net realisable value. The cost of main product is then joint cost minus net realisable value of by-products, scraps or wastes.

Other Costs

- (a) These may be included in cost of inventory provided they are incurred to bring the inventory to their present location and condition. Cost of design, for example, for a custom made unit may be taken as part of inventory cost. (Paragraph 11)
- (b) Interest and other borrowing costs are usually considered as not relating to bringing the inventories to their present location and condition. These costs are therefore not usually included in cost of inventory (Paragraph 12). Interests and other borrowing costs however are taken as part of inventory costs, where the inventory necessarily takes substantial period of time for getting ready for intended sale. Example of such inventory is wine. (See AS 16, Borrowing costs, for further details)



- (c) The standard is silent on treatment of amortisation of intangibles for ascertaining inventory costs. It nevertheless appears that amortisation of intangibles related to production, e.g. patents right of production or copyright for a publisher should be taken as part of inventory costs.
- (d) Exchange differences are not taken in inventory costs under Indian GAAP.

Exclusions from the cost of inventories (Paragraph 13)

In determining the cost of inventories, it is appropriate to exclude certain costs and recognise them as expenses in the period in which they are incurred. Examples of such costs are:

- (a) Abnormal amounts of wasted materials, labour, or other production costs;
- (b) Storage costs, unless the production process requires such storage;
- (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition;
- (d) Selling and distribution costs.

Cost Formula (Paragraph 16)

Mostly inventories are purchased / made in different lots and unit cost of each lot frequently differs. In all such circumstances, determination of closing inventory cost requires identification of units in stock to have come from a particular lot. This specific identification is best wherever possible (Para 14). In all other cases, the cost of inventory should be determined by the First-In First-Out (FIFO), or Weighted Average cost formula. The formula used should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

Other techniques of cost measurement

- (a) Instead of actual, the standard costs may be taken as cost of inventory provided standards fairly approximate the actual. Such standards (for finished or partly finished units) should be set in the light of normal levels of material consumption, labour efficiency and capacity utilisation. The standards so set should be regularly reviewed and if necessary, be revised to reflect current conditions. (Paragraph 18)
- (b) In retail business, where a large number of rapidly changing items are traded, the actual costs of items may be difficult to determine. The units dealt by a retailer however, are usually sold for similar gross margins and a retail method to determine cost in such retail trades makes use of the fact. By this method, cost of inventory is determined by reducing sale value of unsold stock by appropriate average percentage of gross margin. (Paragraph 19)



Example 5

A trader purchased certain articles for Rs. 85,000. He sold some these articles for Rs. 1,05,000. The average percentage of gross margin is 25% on cost. Opening stock of inventory at cost was Rs. 15,000. Cost closing inventory is shown below.

	Rs.
Sale value of opening stock and purchase (Rs. 85,000 + Rs. 15,000) x 1.25	1,25,000
Sales	1,05,000
Sale value of unsold stock	20,000
Less: Gross Margin (Rs. 20,000 / 1.25) x 0.25	4,000
Cost of inventory	16,000

Estimates of Net Realisable Value

Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date. (Paragraph 22)

Comparison of Cost and Net Realisable Value

- (a) The comparison between cost and net realisable value should be made on item-by-item basis. In some cases nevertheless, it may be appropriate to group similar or related items. (Paragraph 21)

Example 6

The cost, net realisable value and inventory value of two items that a company has in its inventory are given below:

	Cost	Net Realisable Value	Inventory Value
	Rs.	Rs.	Rs.
Item 1	50,000	45,000	45,000
Item 2	20,000	24,000	20,000
Total	70,000	69,000	65,000

Estimates of NRV should be based on evidence available at the time of estimation



As per paragraph 3, net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale. Paragraph 22 provides that estimates of net realisable value are to be based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the balance sheet date to the extent that such events confirm the conditions existing at the balance sheet date.

NRV of materials held for use or disposal

As per paragraph 24, materials and other supplies held for use in the production of inventories are not written down below cost if the selling price of finished product containing the material exceeds the cost of the finished product. The reason is, as long as these conditions hold the material realises more than its cost as shown below.

An enterprise may either (i) dispose off the material without incorporating it in finished product to realise its current price or (ii) Incorporate the material in finished product to realise the selling price less costs of making (Incremental Revenue)

An enterprise prefers to incorporate the material in finished product when:

Incremental Revenue by making > Current price of material

Or when: (Selling price of finished product – Cost to make) > Current price of material

Or when: (Selling price of finished product > (Current price of material + Cost to make)

Or when: (Selling price of finished product > Relevant cost of finished product

As long as selling price of finished product is more than relevant cost of finished product, the enterprise incorporates the material in finished product and realises incremental revenue rather than current price of material. Thus If selling price of finished product is more than relevant cost of finished product, the enterprise incorporates the material in finished product and NRV is incremental revenue.

(a) If selling price of finished product is less than relevant cost of finished product, the enterprise disposes of the material and NRV is current price of material

If current price of material is greater than material cost

Observe that the NRV is either current price of material or higher, i.e. incremental revenue. Thus, if current price of material is greater than material cost, NRV always exceeds the material cost. The inventories in all such cases are therefore valued at cost.

If current price of material is less than material cost

As before, the NRV is either current price of material or higher, i.e. incremental revenue. If current price of material is less than material cost, and NRV is current price of material (i.e.



when enterprise prefers to dispose of the material at current price) the NRV is less than material cost. The inventory is therefore written down to NRV, i.e. current price [See Example 12(a) below].

For the reason stated above, paragraph 24 further provides that when there has been a decline in the price of materials and it is estimated that the cost of finished products will exceed net realisable value (i.e. when enterprise prefers to dispose of the material at current price) the materials are written down to net realisable value. In such circumstances, the replacement cost (i.e. current price of material) may be the best available measure of net realisable value.

If current price of material is less than material cost, and NRV is incremental revenue, (i.e. when enterprise prefers to make the product) the NRV is more than current price of material but may or may not exceed the material cost. If the incremental revenue exceeds material cost, the inventory is valued at cost [See Example 14(b) below]. If the incremental revenue is less than material cost, the inventory is valued at NRV, i.e. incremental revenue [See Example 12(c) below].

*Example 7*

Raw materials inventory of a company includes 1 Kg. of certain material purchased at Rs. 100 per Kg. The price of the material is on decline and replacement cost of the inventory at the year-end is Rs. 80 per Kg. It is possible to incorporate the material in a finished product. The conversion cost (wages and overheads) is Rs. 120.

Inventory values for expected selling prices of the finished product (a) Rs. 195 (b) Rs. 230 and (c) Rs. 210. are shown below.

In all cases, current price of material (Rs. 80) is less than material cost Rs. 100

Case (a): Selling price = Rs. 195

Incremental revenue = Rs. 195 – Rs. 120 = Rs. 75

Current price of material = Rs. 80

It is better to not to make the product.

Net realisable value = Rs. 80

Cost of material = Rs. 100

Value of inventory = Rs. 80

Case (b): Selling price = Rs. 230

Incremental revenue = Rs. 230 – Rs. 120 = Rs. 110

Current price of material = Rs. 80



It is better to make the product.

Net realisable value = Rs. 110

Cost of material = Rs. 100

Value of inventory = Rs. 100

Case (c): Selling price = Rs. 210

Incremental revenue = Rs. 210 – Rs. 120 = Rs. 90

Current price of material = Rs. 80

It is better to make the product.

Net realisable value = Rs. 90

Cost of material = Rs. 100

Value of inventory = Rs. 90

Review of net realisable value at each balance sheet date

If an item of inventory remains at more than one balance sheet dates, paragraph 25 requires reassessment of net realisable value of the item at each balance sheet date. The AS 2 is silent whether an item of inventory carried at net realisable value, can be written up on subsequent increase of net realisable value. The IAS 2, Inventory permits such write-ups.

Disclosures

Paragraph 26 requires financial statements to disclose:

The accounting policies adopted in measuring inventories, including the cost formula used; and

The total carrying amount of inventories and its classification appropriate to the enterprise.

Paragraph 27 requires disclosure of carrying amounts and changes in them during an accounting period for each class of inventory, e.g. raw materials, components, work-in-progress, finished stock, stores, spares and loose tools.

### 9.3 CASH FLOW STATEMENT (AS 3)

Traditional financial statements comprised of a balance sheet portraying at the end of accounting period, resources controlled by the reporting enterprise together with sources of funds used for their acquisition and a statement of income, showing income, expenses and profit earned or loss incurred by the reporting enterprise during the accounting period. It was however noticed that due to use of accrual basis of accounting, recognition of financial elements, e.g. assets, liabilities, income, expenses and equity, coincide with the events to which they relate rather than with cash receipts or payments. For this reason, traditional



financial statements fail to inform the users the way the reporting enterprise has generated cash and the way these were utilised during the accounting period. To a person, less accustomed with accounting practices, it may sometimes appear perplexing to observe that despite earning large profit, an enterprise is left with very little cash to pay dividends. The need for inclusion of a summary of cash receipts and payments in the financial statements of the reporting enterprise was therefore recognised. The summary of cash receipts and payments during an accounting period is called the Cash Flow Statement.

A simple example is given below to illustrate the relation of cash flow with profitability of an enterprise.

### Status of AS 3

In 1997, the Accounting Standard 3, Cash Flow Statement, replaced its predecessor, the recommendatory Accounting Standard 3, Changes in Financial Position, (Statement showing Changes in Financial Position is commonly known as Fund Flow Statement) issued in June 1981. The standard is mandatory for Level 1 enterprises in respect of accounting periods commencing on or after April 1, 2001. The Level II and Level III enterprises are encouraged but not required to apply the standard.

All listed companies in India are required by Clause 32 of the listing agreements with stock exchanges to prepare and present cash flow statements by indirect method in accordance with AS 3.

Meaning of the term cash for cash flow statements (Paragraph 5)

Cash for the purpose of cash flow statement consists of the following:

- (a) Cash in hand and deposits repayable on demand with any bank or other financial institutions and
- (b) Cash equivalents, which are short term, highly liquid investments that are readily convertible into known amounts of cash and are subject to insignificant risk or change in value. A short-term investment is one, which is due for maturity within three months from the date of acquisition. Investments in shares are not normally taken as cash equivalent, because of uncertainties associated with them as to realisable value.

Note:

For the purpose of cash flow statement, 'cash' consists of at least three balance sheet items, viz. cash in hand; demand deposits with banks etc. and investments regarded as cash equivalents. For this reason, the paragraph 42 of the standard requires enterprises to give a break-up of opening and closing cash shown in their cash flow statements. This is presented as a note to cash flow statement.



### Meaning of the term cash flow (Paragraph 5)

Cash flows are inflows (i.e. receipts) and outflows (i.e. payments) of cash and cash equivalents. Any transaction, which does not result in cash flow, should not be reported in the cash flow statement. Movements within cash or cash equivalents are not cash flows because they do not change cash as defined by AS 3, which is sum of cash, bank and cash equivalents. For example, acquisitions of cash equivalent investments or cash deposited into bank are not cash flows.

It is important to note that a change in cash does not necessarily imply cash flow. For example suppose an enterprise has a bank balance of USD 10,000, stated in books at Rs. 4,90,000 using the rate of exchange Rs. 49/USD prevailing on date of receipt of dollars. If the closing rate of exchange is Rs. 50/USD, the bank balance will be restated at Rs. 5,00,000 on the balance sheet date. The increase is however not a cash flow because neither there is any cash inflow nor there is any cash outflow.

### Types of cash flow

Cash flows for an enterprise occur in various ways, e.g. through operating income or expenses, by borrowing or repayment of borrowing or by acquisition or disposal of fixed assets. The implication of each type of cash flow is clearly different. Cash received on disposal of a useful fixed asset is likely to have adverse effect on future performance of the enterprise and it is completely different from cash received through operating income or cash received through borrowing. It may also be noted that implications cash flow types are interrelated. For example, borrowed cash used for meeting operating expenses is not same as borrowed cash used for acquisition of useful fixed assets.

For the aforesaid reasons, the standard identifies three types of cash flows, i.e. investing cash flows, financing cash flows and operating cash flows. Separate presentation of each type of cash flow in the cash flow statement improves usefulness of cash flow information.

The investing cash flows are cash flows generated by investing activities. The investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The examples of investing cash flows include cash flow arising from investing activities include: (a) receipts from disposals of fixed assets; (b) loan given to / recovered from other entities (other than loans by financial enterprises) (c) payments to acquire fixed assets (d) Interests and dividends earned (other than interests and dividends earned by financial institutions).

The financing cash flows are cash flows generated by financing activities. Financing activities are activities that result in changes in the size and composition of the owners' capital (including preferences share capital in the case of company) and borrowings of the enterprise. Examples include issue of shares / debentures, redemption of debentures / preference shares,





payment of dividends and payment of interests (other than interests paid by financial institutions).

The operating cash flows are cash flows generated by operating activities or by other activities that are not investing or financing activities. Operating activities are the principal revenue-producing activities of the enterprise. Examples include, cash purchase and sale of goods, collections from customers for goods, payment to suppliers of goods, payment of salaries, wages etc.

Identifying type of cash flows

Cash flow type depends on the business of the enterprise and other factors. For example, since principal business of financial enterprises consists of borrowing, lending and investing, loans given and interests earned are operating cash flows for financial enterprises and investing cash flows for other enterprises. A few typical cases are discussed below.

Loans/Advances given and Interests earned (See Paragraph 30)

- (a) Loans and advances given and interests earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances given and interests earned on them are investing cash flows for non-financial enterprises.
- (c) Loans and advances given to subsidiaries and interests earned on them are investing cash flows for all enterprises.
- (d) Loans and advances given to employees and interests earned on them are operating cash flows for all enterprises.
- (e) Advance payments to suppliers and interests earned on them are operating cash flows for all enterprises.
- (f) Interests earned from customers for late payments are operating cash flows for non-financial enterprises.

Loans/Advances taken and interests paid (See Paragraph 30)

- (a) Loans and advances taken and interests paid on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Loans and advances taken and interests paid on them are financing cash flows for non-financial enterprises.
- (c) Loans and advances taken from subsidiaries and interests paid on them are investing cash flows for all enterprises.



- (d) Advance taken from customers and interests paid on them are operating cash flows for non-financial enterprises.
- (e) Interests paid to suppliers for late payments are operating cash flows for all enterprises.
- (f) Interests taken as part of inventory costs in accordance with AS 16 are operating cash flows.

Investments made and dividends earned (See Paragraph 30)

- (a) Investments made and dividends earned on them in the ordinary course of business are operating cash flows for financial enterprises.
- (b) Investments made and dividends earned on them are investing cash flows for non-financial enterprises.
- (c) Investments in subsidiaries and dividends earned on them are investing cash flows for all enterprises.

Dividends Paid (See Paragraph 30)

Dividends paid are financing cash outflows for all enterprises.

Income Tax (See Paragraph 34)

- (a) Tax paid on operating income is operating cash outflows for all enterprises
- (b) Tax deducted at source against income are operating cash outflows if concerned incomes are operating incomes and investing cash outflows if the concerned incomes are investment incomes, e.g. interest earned.
- (c) Tax deducted at source against expenses are operating cash inflows if concerned expenses are operating expenses and financing cash inflows if the concerned expenses are financing expenses, e.g. interests paid.

Insurance claims received

- (a) Insurance claims received against loss of stock or loss of profits are extraordinary operating cash inflows for all enterprises.
- (b) Insurance claims received against loss of fixed assets are extraordinary investing cash inflows for all enterprises.

Paragraph 28 of the standard requires separate disclosure of extraordinary cash flows, classifying them as cash flows from operating, investing or financing activities, as may be appropriate.



Profit or loss on disposal of fixed assets

Profit or loss on sale of fixed asset is not operating cash flow. The entire proceeds of such transactions should be taken as cash inflow from investing activity.

Fundamental techniques of cash flow preparation

A cash flow statement is a summary of cash receipts and payments of an enterprise during an accounting period. Any attempt to compile such a summary from cashbooks is impractical due to the large volume of transactions. Fortunately, it is possible to compile such a summary by comparing financial statements at the beginning and at the end of accounting period.

There are two methods, by which operating cash flows can be presented. By direct approach, the operating cash flows are presented under broad headings, e.g. cash received from customers and cash paid to suppliers and employees. By the indirect approach, operating cash flows are obtained by adjusting profits for changes in working capital and for non-cash charges, e.g. depreciation.

Reporting Cash Flows on Net Basis

Paragraph 21 forbids netting of receipts and payments from investing and financing activities. Thus, cash paid on purchase of fixed assets should not be shown net of cash realised from sale of fixed assets. For example, if an enterprise pays Rs. 50,000 in acquisition of machinery and realises Rs. 10,000 on disposal of furniture, it is not right to show net cash outflow of Rs. 40,000. The exceptions to this rule are stated in paragraphs 22 and 24.

As per paragraph 22, cash flows from the following operating, investing or financing activities may be reported on a net basis.

- (a) Cash receipts and payments on behalf of customers, e.g. cash received and paid by a bank against acceptances and repayment of demand deposits.
- (b) Cash receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short, e.g. purchase and sale of investments by an investment company.

Paragraph 24 permits financial enterprises to report cash flows on a net basis in the following three circumstances.

- (a) Cash flows on acceptance and repayment of fixed deposits
- (b) Cash flows on placement and withdrawal deposits from other financial enterprises
- (c) Cash flows on advances/loans given to customers and repayments received therefrom.



### Non-Cash transactions (Paragraph 40)

Investing and financing transactions that do not require the use of cash or cash equivalents, e.g. issue of bonus shares, should be excluded from a cash flow statement. Such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

### Business Purchase

The aggregate cash flows arising from acquisitions and disposals of business units should be presented separately and classified as cash flow from investing activities. (Paragraph 37)

- (a) The cash flows from disposal and acquisition should not be netted off. (Paragraph 39)
- (b) As per paragraph 38, an enterprise should disclose, in aggregate, in respect of both acquisition and disposal of subsidiaries or other business units during the period each of the following:
  - (i) The total purchase or disposal consideration; and
  - (ii) The portion of the purchase or disposal consideration discharged by means of cash and cash equivalents.

### Treatment of current assets and liabilities taken over on business purchase

Business purchase is not operating activity. Thus, while taking the differences between closing and opening current assets and liabilities for computation of operating cash flows, the closing balances should be reduced by the values of current assets and liabilities taken over. This ensures that the differences reflect the increases/decreases in current assets and liabilities due to operating activities only.

### Exchange gains and losses

The foreign currency monetary assets (e.g. balance with bank, debtors etc.) and liabilities (e.g. creditors) are initially recognised by translating them into reporting currency by the rate of exchange transaction date. On the balance sheet date, these are restated using the rate of exchange on the balance sheet date. The difference in values is exchange gain/loss. The exchange gains and losses are recognised in the statement of profit and loss (See AS 11 for details).

The exchange gains/losses in respect of cash and cash equivalents in foreign currency (e.g. balance in foreign currency bank account) are recognised by the principle aforesaid, and these balances are restated in the balance sheet in reporting currency at rate of exchange on balance sheet date. The change in cash or cash equivalents due to exchange gains and losses are however not cash flows. This being so, the net increases/decreases in cash or cash equivalents in the cash flow statements are stated exclusive of exchange gains and losses.



The resultant difference between cash and cash equivalents as per the cash flow statement and that recognised in the balance sheet is reconciled in the note on cash flow statement. (Paragraph 25)

#### Disclosures

Paragraph 45 requires an enterprise to disclose the amount of significant cash and cash equivalent balances held by it but not available for its use, together with a commentary by management. This may happen for example, in case of bank balances held in other countries subject to such exchange control or other regulations that the fund is practically of no use.

Paragraph 47 encourages disclosure of additional information, relevant for understanding the financial position and liquidity of the enterprise. Such information may include:

- (a) The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities; and
- (b) The aggregate amount of cash flows required for maintaining operating capacity, e.g. purchase of machinery to replace the old, separately from cash flows that represent increase in operating capacity, e.g. additional machinery purchased to increase production.

*Note: For details regarding preparation of Cash Flow Statement and Problems based on practical application of AS 3, students are advised to refer unit 2 of Chapter 3.*

#### **9.4 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 recognises 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 recognised 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.



## 9.5 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 2005-06 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 2004-05. On 31/03/05, the estimated net realisable value of this stock was Rs. 15,000. The revised estimate of net realisable value included in closing stock of 2005-06 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 2004-05. 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 2005-06 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)

= Rs. 1,00,000  $(1 - 0.17)^2$  = 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.



## 9.6 DEPRECIATION ACCOUNTING (AS 6)

Where an asset, e.g. machinery, generates revenue over more than one accounting period, the matching principle demands that the cost of the asset be recognised over same number of accounting periods. Also, the allocation, as far as possible should be in the proportion of revenue generated by the asset. Depreciation for an accounting period is the cost of assets allocated to that accounting period. However, the allocated historical cost of an asset may not always reflect the appropriate charge against revenue. This can happen for example, when the asset has a terminal value or when the asset is revalued. For this reason, depreciation for an accounting period is regarded as amount of depreciable value allocated to an accounting period. The depreciable value is historical cost  $\pm$  Change in historical cost due to revaluation or otherwise – terminal value expected on disposal of the asset.

The depreciation is a non-cash charge, i.e. a charge of depreciation reduces profit available for distribution without reducing the available cash. The cash thus retained in the business is intended to be used for replacement of the depreciable asset. For this reason, section 205 of the Companies Act 1956, provides that companies can pay dividend only out of profit available after charging depreciation in accordance with subsection 2 of that section. For the purpose, Schedule XIV of the Companies Act prescribes certain rates of depreciation. These are minimum rates of depreciation a company must charge.

Accounting standard 6, sets the broad principles for computation of depreciation without prescribing any specific rate or method of depreciation. Enterprises other than companies to which the standard applies, must compute and charge depreciation in accordance with the standard. In case of companies, the depreciation charged should be higher of (i) depreciation under Companies Act (ii) depreciation as per AS 6.

AS 6 is mandatory in respect of accounting periods commencing on or after April 1, 1995. It applies to all enterprises.

Land has indefinite life and hence does not permit allocation of value over finite number of accounting periods. Hence, the standard does not apply to land, unless it has a limited useful life. The standard applies to all depreciable assets except the following to which special considerations apply:

- (i) forests, plantations and similar regenerative natural resources
- (ii) wasting assets including expenditure on the exploration for and extraction of minerals, oils, natural gas and similar non-regenerative resources
- (iii) expenditure on research and development
- (iv) livestock



Accounting Standard 6 defines depreciation as a measure of the wearing out, consumption or other loss of value of depreciable asset arising from use, efflux of time or obsolescence through technology and market changes. Depreciation is allocated so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined.

"Depreciable assets" are assets which:

1. are expected to be used during more than one accounting period; and
2. have a limited useful life; and
3. are held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and not for the purpose of sale in the ordinary course of business.

"Useful life" is either

- (a) the period over which a depreciable asset is expected be used by the enterprise; or
- (b) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

"Depreciable amount" of a depreciable asset is its historical cost, or other amount substituted for historical cost in the financial statements, less estimated residual value.

The depreciable amount of a depreciable asset should be allocated on a systematic basis to each accounting period during the useful life of the asset. (Paragraph 20)

The useful life of a depreciable asset should be estimated after considering:

expected physical wear and tear

- (i) obsolescence and
- (ii) legal or other limits on the use of the asset. (Paragraph 22)

The useful lives of major depreciable assets or classes of depreciable assets may be reviewed periodically. Where there is a revision of the estimated useful life of an asset, the unamortised depreciable amount should be charged over the revised remaining useful life. (Paragraph 23)

#### Example 1

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. The estimate of remaining useful life after third year was reassessed at 5 years.

Depreciation per year charged for three years = Rs. 1,20,000 / 10 = Rs. 12,000

WDV of the machine at the end of third year = Rs. 1,20,000 – Rs. 12,000 × 3 = Rs. 84,000.





Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 5 years

Depreciation for the fourth year onwards = Rs. 84,000 / 5 = Rs. 16,800.

Additions and Extensions (Paragraph 24)

- (a) Where an addition or extension retains a separate identity and is capable of being used after the existing asset is disposed off, depreciation should be provided independently on the basis of an estimate of its own useful life.
- (b) Where an addition or extension becomes an integral part of an existing asset, it should be depreciated over the asset's remaining useful life. The depreciation on such addition or extension may also be provided at the rate applied to the existing asset.

#### Example 2

The estimated working life of a machine is 6 years. The machine is used with an attachment having a useful life of 10 years. The cost of the machine and that of the attachment are Rs. 60,000 and Rs. 6,000 respectively. The terminal value is zero for both. Straight-line depreciation is in use.

#### Depreciation for the year

- (a) if the attachment retains a separate identity and is capable of being used after the machine is disposed off = Rs. 60,000 / 6 + Rs. 6,000 / 10 = Rs. 10,600
- (b) if the attachment becomes an integral part of the machine = Rs. 66,000 / 6 = Rs. 11,000

#### Change in depreciable amount

- (a) The historical cost of a depreciable asset may change due to increase or decrease in long-term liability on account of exchange fluctuations (See note), price adjustments, changes in duties or other similar factors. In these cases, depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual life of the asset. (Paragraph 25)
- (b) Where the depreciable assets are revalued, the provision for depreciation should be based on the revalued amount and on the estimate of the remaining useful lives of such assets. In case the revaluation has a material effect on the amount of depreciation, the same should be disclosed separately in the year in which revaluation is carried out. (Para 26)

The aforesaid two requirements ensure that no amortisation of depreciable amounts remain pending after the assets cease to be useful. Since an asset does not generate any revenue



after its useful is over, any amortisation charged against revenue after such time, defeats the principle of matching revenue and costs.

Example 3

A machine of cost 1,20,000 is depreciated straight-line assuming 10 year working life and zero residual value for three years. At the end of third year, the machine was revalued upwards by Rs. 6,000 the remaining useful life was reassessed at 9 years.

Depreciation per year charged for three years = Rs. 1,20,000 / 10 = Rs. 12,000

WDV of the machine at the end of third year = Rs. 1,20,000 – Rs. 12,000 × 3 = Rs. 84,000.

Depreciable amount after revaluation = Rs. 84,000 + Rs. 6,000 = Rs. 90,000

Remaining useful life as per previous estimate = 7 years

Remaining useful life as per revised estimate = 9 years

Depreciation for the fourth year onwards = Rs. 90,000 / 9 = Rs. 10,000.

Change in method of charging depreciation (Paragraph 21)

The depreciation method selected should be applied consistently from period to period. A change from one method of providing depreciation to another should be made only if the adoption of the new method is required by statute or for compliance with an accounting standard or if it considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise. When such a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use.

The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In case the change in the method results in deficiency in depreciation in respect of past years, the deficiency should be charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus should be credited to the statement of profit and loss. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

Example 4

A company acquired a machine on 01/04/01 for Rs. 5,00,000. The company charged straight-line depreciation based on 10 year working life estimate and residual value Rs. 50,000 upto 2003-04. From 2004-05, the company decided to change to 20% reducing balance method of depreciation. Show adjustment required in books of the company.

Solution

Annual depreciation charged by the company upto 2003-04



= (Rs. 5,00,000 – Rs. 50,000)/10 = Rs. 45,000

WDV of machine at the end of 2003-04 = Rs. 5,00,000 – Rs. 45,000 × 3 = Rs. 3,65,000

WDV of machine at the end 2003-04 (by reducing balance method)

= Rs. 5,00,000 (1 – 0.20)<sup>3</sup> = Rs. 2,56,000

Depreciation to be charged in 2004-05

= (Rs. 3,65,000 – Rs. 2,56,000) + 20% of Rs. 2,56,000 = Rs. 1,60,200

Books of the company

	Rs. 000	Rs. 000
Depreciation	160.2	
To Machine		160.2
Profit & Loss A/c	160.2	
To Depreciation		160.2

Machine A/c

	Rs. 000		Rs. 000
To Balance b/d	365.0	By Depreciation	160.2
		By Balance c/d	204.8
	365.0		365.0

### Disclosures

(a) The following information should be disclosed in the financial statements:

- ◆ The historical cost or other amount substituted for historical cost of each class of depreciable assets;
- ◆ Total depreciation for the period for each class of assets and the related accumulated depreciation.

(b) In addition to above, the following information should be disclosed in the financial statements along with the disclosure of other accounting policies:

- ◆ depreciation methods used; and
- ◆ depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.



- (c) If any depreciable asset is disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, should be disclosed separately.

### 9.7 CONSTRUCTION CONTRACTS (AS 7)

Accounting Standard 7 prescribes the principles of accounting for construction contracts in the financial statements of contractors. The focus of the standard is on principles of revenue recognition by the contractors. The standard was initially issued in December 1983 and had the title "Accounting for Construction Contracts". The standard was revised later and the revised standard applies to all enterprises in respect of construction contracts entered into during accounting periods commencing on or after April 1, 2003. The earlier standard applies to construction contracts entered into during accounting periods commencing on or before 31/03/03.

A construction contract is one, by which a contractor agrees to build some asset for his customer. The contractor's profit is the excess of contract price over construction costs. The contract price may or may not be fixed. In a fixed price contract, the price is agreed as fixed sum. In some cases, the contract may require the customer to pay additional sums to compensate the contractor against cost escalations. In a cost plus contract, the customer undertakes to reimburse specified costs together with a fee calculated as percentage on reimbursable costs. The fee is the contractor's margin of profit.

#### Percentage completion method

Construction contracts are mostly long term, i.e. they take more than one accounting year to complete. This means, the final outcome (profit/ loss) of a construction contract can be determined only after a number of years from the year of commencement of construction are over. It is nevertheless possible to recognise revenue annually in proportion of progress of work to be matched with corresponding construction costs incurred in that year. This method of accounting, called the percentage completion method, provides useful information on the extent of contract activity and performance during an accounting period.

The percentage completion method suffers from a serious drawback viz. anticipation of profit. Since the method recognises revenue pending final outcome of a contract is known, it is possible that an enterprise may distribute dividend based on reported profit of a year, while final result is loss. To avoid such possibilities, percentage completion method should be used with caution. The AS 7 prescribes that the percentage completion method should not be used unless it is possible to make a reasonable estimate of the final outcome of the contract. Also, paragraph 35 of the standard provides that whenever total contract cost is expected to exceed the total contract revenue, the loss should be recognised as an expense immediately.

As per paragraph 22, the outcome of fixed price contracts can be estimated reliably when all the following conditions are satisfied:



- (i) total contract revenue can be measured reliably;
- (ii) it is probable that the economic benefits associated with the contract will flow to the enterprise;
- (iii) both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
- (iv) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

As per paragraph 23, the outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

- (i) it is probable that the economic benefits associated with the contract will flow to the enterprise; and
- (ii) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

Example 1 (The percentage completion method)

X Ltd. commenced a construction contract on 01/04/05. The fixed contract price agreed was Rs. 2,00,000. The company incurred Rs. 81,000 in 2005-06 for 45% work and received Rs. 79,000 as progress payment from the customer. The cost incurred in 2006-07 was Rs. 89,000 to complete the rest of work.

Solution:

Profit & Loss A/c

Year		Rs. 000	Year		Rs. 000
2005-06	To Construction Costs (for 45% work)	81	2005-06	By Contract Price (45% of Contract Price)	90
	To Net profit (for 45% work)	9			
		90			90
2006-07	To Construction costs (for 55% work)	89	2006-07	By Contract Price (55% of Contract Price)	110
	To Net Profit (for 55% work)	21			
		110			110



Customer A/c					
Year		Rs. 000	Year		Rs. 000
2005-06	To Contract Price	90	2005-06	By Bank	79
				By Balance c/d	11
		90			90
2006-07	To Balance b/d	11	2006-07	By Bank	
	To Contract Price	110			121
		121			121

The amount of contract revenue recognised in the statement of profit and loss as per the requirements of AS 7 should be considered as turnover according to Accounting Standards Interpretation (ASI) 29. This means, the revenue recognised by percentage completion method should not be described as work-in progress. It may also be noted that as per the scheme for applicability of accounting standards, enterprises having turnover exceeding Rs. 50 crores treated as level I enterprises. The implication of ASI 29 is, that the proportionate revenue recognised in the statement of profit and loss by a contractor, should be taken in computation of turnover for the purpose of the scheme. This is important because level I enterprises are required to comply with all applicable accounting standards in entirety.

The paragraph 31 provides that the percentage completion method should not be applied if the outcome of a construction contract cannot be estimated reliably. In such cases:

- (a) revenue should be recognised only to the extent of contract costs incurred of which recovery is probable; and
- (b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should however be recognised as an expense immediately.

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method. (Para 34)

Example 2

X Ltd. commenced a construction contract on 01/04/05. The contract price agreed was reimbursable cost plus 20%. The company incurred Rs. 1,00,000 in 2005-06, of which Rs. 90,000 is reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at Rs. 5,000. The other costs to complete the contract could not be estimated reliably.

The Profit & Loss A/c extract of X Ltd. for 2005-06 is shown below:



Profit & Loss A/c

	Rs. 000		Rs.000
To Construction Costs	100	By Contract Price	90
To Provision for loss	5	By Net loss	15
	105		105

Treatment of costs relating to future activity (Para 26)

Under the percentage of completion method, contract revenue is recognised as revenue in the statement of profit and loss in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the statement of profit and loss in the accounting periods in which the work to which they relate is performed. The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

Uncollectable Contract Revenue (Para 27)

When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the statement of profit and loss, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

Stage of Completion (Para 29)

The stage of completion of a contract may be determined in a variety of ways. Depending on the nature of the contract, the methods may include:

- (a) the proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers may not necessarily reflect the work performed.

Example 3

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data.



	Rs. 000
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

*Solution*

	Rs. 000
A. Cost incurred to date	390
B. Estimate of cost to completion	260
C. Estimated total cost	650
D. Degree of completion (A/C)	60%
E. Revenue Recognized (60% of 600)	360
Total foreseeable loss (650 – 600)	50
Less: Loss for current year (E – A)	30
Expected loss to be recognised immediately	20

Profit & Loss A/c

	Rs.		Rs.
To Construction costs	390	By Contract Price	360
To Provision for loss	20	By Net Loss	50
	410		410

Combining and Segmenting Construction Contracts

A contractor may undertake a number of contracts. The percentage completion method may not however be appropriate in all cases. Each of the contracts should be tested on the basis of respective facts for electing the appropriate method of revenue recognition. The standard identifies certain cases where for the purposes of accounting, (i) More than one contract can be taken as one and (ii) a single contract can be taken as to comprise of more than one contract.

- (a) When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:





- (i) separate proposals have been submitted for each asset;
  - (ii) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
  - (iii) the costs and revenues of each asset can be identified.
- (b) A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:
- (i) the group of contracts is negotiated as a single package;
  - (ii) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
  - (iii) the contracts are performed concurrently or in a continuous sequence.
- (c) A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. As per paragraph 9, the construction of the additional asset should be treated as a separate construction contract when:
- (i) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or
  - (ii) the price of the asset is negotiated without regard to the original contract price.

Contract Revenue and costs

- (a) As per paragraph 10, contract revenue should comprise:
- (i) the initial amount of revenue agreed in the contract; and
  - (ii) variations in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.
- (b) As per paragraph 15, contract costs should comprise:
- (i) costs that relate directly to the specific contract;
  - (ii) costs that are attributable to contract activity in general and can be allocated to the contract; and
  - (iii) such other costs as are specifically chargeable to the customer under the terms of the contract.



Note:

1. Direct costs can be reduced by incidental income, e.g. sale of surplus material, not included in contract revenue. (Paragraph 16)
2. The allocation of indirect costs should be based on normal levels of construction activity. The allocable costs may include borrowing costs as per AS 16. (Paragraph 17)

Changes in Estimates (Para 37)

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with AS 5. The changed estimates are used in determination of the amount of revenue and expenses recognised in the statement of profit and loss in the period in which the change is made and in subsequent periods.

Disclosure

- (a) The paragraph 38 requires an enterprise to disclose:
  - (i) the amount of contract revenue recognised as revenue in the period;
  - (ii) the methods used to determine the contract revenue recognised in the period; and
  - (iii) the methods used to determine the stage of completion of contracts in progress.
- (b) The paragraph 39 requires the following disclosures in respect of contracts in progress at the reporting date:
  - (c) the aggregate amount of costs incurred and recognised profits (less recognised losses) upto the reporting date;
    - (i) the amount of advances received; and
    - (ii) the amount of retentions.
- (d) The Paragraph 41 requires an enterprise to present:
  - (i) the gross amount due from customers for contract work as an asset; and
  - (ii) the gross amount due to customers for contract work as a liability.

## 9.8 REVENUE RECOGNITION(AS 9)

This statement was issued by ICAI in the year 1985 and in the initial years it was recommendatory for only level I enterprises and but was made mandatory for enterprise in India from April 01, 1993.



Revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends. Revenue is measured by the charges made to customers or clients for goods supplied and services rendered to them and by the charges and rewards arising from the use of resources by them. In an agency relationship, the revenue is the amount of commission and not the gross inflow of cash, receivables or other consideration.

This Statement does not deal with the following aspects of revenue recognition to which special considerations apply:

- i. Revenue arising from construction contracts;
- ii. Revenue arising from hire-purchase, lease agreements;
- iii. Revenue arising from government grants and other similar subsidies;
- iv. Revenue of insurance companies arising from insurance contracts.

Examples of items not included within the definition of "revenue" for the purpose of this Statement are:

- i. Realised gains resulting from the disposal of, and unrealised gains resulting from the holding of, non-current assets e.g. appreciation in the value of fixed assets;
- ii. Unrealised holding gains resulting from the change in value of current assets, and the natural increases in herds and agricultural and forest products;
- iii. Realised or unrealised gains resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;
- iv. Realised gains resulting from the discharge of an obligation at less than its carrying amount;
- v. Unrealised gains resulting from the restatement of the carrying amount of an obligation.

### Sale of Goods

A key criterion for determining when to recognise revenue from a transaction involving the sale of goods is that the seller has transferred the property in the goods to the buyer for a consideration. The transfer of property in goods, in most cases, results in or coincides with the transfer of significant risks and rewards of ownership to the buyer. However, there may be situations where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such situations is recognised at the time of transfer of significant risks and rewards of ownership to the buyer.



At certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases when sale is assured under a forward contract or a government guarantee or where market exists and there is a negligible risk of failure to sell, the goods involved are often valued at net realisable value. Such amounts, while not revenue as defined in this Statement, are sometimes recognised in the statement of profit and loss and appropriately described.

### Example 1

The stages of production and sale of a producer are as follows (all in Rupees):

Stage	Activity	Costs to date	Net Realisable Value
A	Raw Materials	10,000	8,000
B	WIP 1	12,000	13,000
C	WIP 2	15,000	19,000
D	Finished Product	17,000	30,000
E	For Sale	17,000	30,000
F	Sale Agreed	17,000	30,000
G	Delivered	18,000	30,000
H	Paid For	18,000	30,000

State and explain the stage at which you think revenue will be recognized and how much would be gross profit and net profit on a unit of this product?

Solution:

According to AS – 9, sales will be recognized only following two conditions are satisfied:

1. The sale value is fixed and determinable.
2. property of the goods are transferred to the customer.

Both these conditions are satisfied only at Stage F when sales are agreed upon at a price and goods allocated for delivery purpose.

Gross Profit will be determined at Stage E, when goods are ready for sale after all necessary process for production is over i.e. Rs. 13,000 (30,000 – 17,000).

Net Profit will be determined at Stage H, when goods are delivered and payment collected i.e. Rs. 12,000 (30,000 – 18,000).

### Rendering of Services

Revenue from service transactions is usually recognised as the service is performed, either by the proportionate completion method or by the completed service contract method.



Proportionate completion method is a method of accounting which recognises revenue in the statement of profit and loss proportionately with the degree of completion of services under a contract. Here performance consists of the execution of more than one act. Revenue is recognised proportionately by reference to the performance of each act.

Completed service contract method is a method of accounting which recognises revenue in the statement of profit and loss only when the rendering of services under a contract is completed or substantially completed. In this method performance consists of the execution of a single act. Alternatively, services are performed in more than a single act, and the services yet to be performed are so significant in relation to the transaction taken as a whole that performance cannot be deemed to have been completed until the execution of those acts. The completed service contract method is relevant to these patterns of performance and accordingly revenue is recognised when the sole or final act takes place and the service becomes chargeable

Use by Others of Enterprise Resources Yielding Interest, Royalties and Dividends

Use by others of such enterprise resources gives rise to:

- i. Interest: charges for the use of cash resources or amounts due to the enterprise. Revenue is recognized on a time proportion basis taking into account the amount outstanding and the rate applicable.
- ii. Royalties: charges for the use of such assets as know-how, patents, trade marks and copyrights. Revenue is recognized on an accrual basis in accordance with the terms of the relevant agreement.
- iii. Dividends: rewards from the holding of investments in shares. Revenue is recognized when the owner's right to receive payment is established.

#### Effect of Uncertainties on Revenue Recognition

Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, revenue recognition is postponed to the extent of uncertainty involved. In such cases:

When the uncertainty relating to collectability arises subsequent to the time of sale or the rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.

An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits, the recognition of revenue is postponed.

#### Disclosure



An enterprise should disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

Example 2

A public sector company is trading gold in India for its customers, after purchasing gold the price of gold is fixed within 120 days as per rules and regulations of Indian Bullion Market by the customer. At the close of year, price of some gold was not fixed on March 31, 2006. The details are given below:

Quantity of Gold	=	10,000 TT Bars
Gold Rate as on March 31, 2006	=	Rs. 275 per TT Bar
Gold Rate was fixed on June 26, 2006 before the finalization of accounts of company	=	Rs. 273 per TT Bar

Calculate the amount of sales regarding 10,000 TT Bars to be booked in the company's account for the year ended March 31, 2006.

Solution:

We need to refer to AS 5 along with AS 9 in this case, since gold is an item which has ready market hence they should be valued at the market price. So, as event occurring after the balance sheet date, the price of gold is fixed at Rs. 273 per TT Bar, gold will be valued at that rate.

**9.9 ACCOUNTING FOR FIXED ASSETS (AS10)**

After introduction of AS – 16; 19 & 26, provisions relating to respective AS are held withdrawn and the rest is mandatory from the accounting year 1-4-2000.

This statement does not deal with accounting for the following items to which special considerations apply:

- i. Forests, plantations and similar regenerative natural resources.
- ii. Wasting assets including mineral rights, expenditure on the exploration for and extraction of minerals, oil, natural gas and similar non-regenerative resources.
- iii. Expenditure on real estate development and
- iv. Livestock.

Identification of Fixed Assets

Fixed asset is an asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business.



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

#### Components of Cost

Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or financial statements. When this amount is shown net of accumulated depreciation, it is termed as net book value.

The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the asset to its working condition for its intended use; any trade discounts and rebates are deducted in arriving at the purchase price.

The cost of a fixed asset may undergo changes subsequent to its acquisition or construction on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost. If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

#### Self-constructed Fixed Assets

Included in the gross book value are costs of construction that relate directly to the specific asset and costs that are attributable to the construction activity in general and can be allocated to the specific asset. Any internal profits are eliminated in arriving at such costs.

#### Example

ABC Ltd. is constructing a fixed asset. Following are the expenses incurred on the construction:

Materials	Rs. 10,00,000
Direct Expenses	Rs. 2,50,000
Total Direct Labour	Rs. 5,00,000
(1/10 <sup>th</sup> of the total labour time was chargeable to the construction)	
Total office & administrative expenses	Rs. 8,00,000
(5% is chargeable to the construction)	
Depreciation on the assets used for the construction of this assets	Rs. 10,000

Calculate the cost of fixed assets.



**Solution:**

Calculation of the cost of construction of Assets

Particulars	Rs.
Direct Materials	1,000,000
Direct Labour	50,000
Direct Expenses	250,000
Office & Administrative Expenses	40,000
Depreciation	10,000
Cost of the Asset	1,350,000

Non-monetary Consideration

When a fixed asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident.

When a fixed asset is acquired in exchange for shares or other securities in the enterprise, it is usually recorded at its fair market value, or the fair market value of the securities issued, whichever is more clearly evident.

Fair market value is the price that would be agreed to in an open and unrestricted market between knowledgeable and willing parties dealing at arm's length who are fully informed and are not under any compulsion to transact.

Improvements and Repairs

Any expenditure that increase the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity.

The cost of an addition or extension to an existing asset, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

Amount Substituted for Historical Cost

The revalued amounts of fixed assets are presented in financial statements either by restating both the gross book value and accumulated depreciation so as to give a net book value equal to the net revalued amount or by restating the net book value by adding therein the net increase on account of revaluation.

Different bases of valuation are sometimes used in the same financial statements to determine the book value of the separate items within each of the categories of fixed assets or for the





different categories of fixed assets. In such cases, it is necessary to disclose the gross book value included on each basis.

It is not appropriate for the revaluation of a class of assets to result in the net book value of that class being greater than the recoverable amount of the assets of that class.

An increase in net book value arising on revaluation of fixed assets is normally credited directly to owner's interests under the heading of revaluation reserves and is regarded as not available for distribution. A decrease in net book value arising on revaluation of fixed assets is charged to profit and loss statement except that, to the extent that such a decrease is considered to be related to a previous increase on revaluation that is included in revaluation reserve.

#### Retirements and Disposals

Items of fixed assets that have been retired from active use and are held for disposal are stated at the lower of their net book value and net realisable value and are shown separately in the financial statements. Any expected loss is recognised immediately in the profit and loss statement.

On disposal of a previously revalued item of fixed asset, the difference between net disposal proceeds and the net book value is normally charged or credited to the profit and loss statement except that, to the extent such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or utilised, it is charged directly to that account. The amount standing in revaluation reserve following the retirement or disposal of an asset which relates to that asset may be transferred to general reserve.

#### Hire Purchases

In the case of fixed assets acquired on hire purchase terms, although legal ownership does not vest in the enterprise, such assets are recorded at their cash value, which, if not readily available, is calculated by assuming an appropriate rate of interest. They are shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

#### Joint Ownership

Where an enterprise owns fixed assets jointly with others, the extent of its share in such assets, and the proportion in the original cost, accumulated depreciation and written down value are stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets is grouped together with similar fully owned assets. Details of such jointly owned assets are indicated separately in the fixed assets register.



### Goodwill

Goodwill, in general, is recorded in the books only when some consideration in money or money's worth has been paid for it. As a matter of financial prudence, goodwill is written off over a period. However, many enterprises do not write off goodwill and retain it as an asset.

### Patents

Patents are normally acquired in two ways: (i) by purchase, in which case patents are valued at the purchase cost including incidental expenses, stamp duty, etc. and (ii) by development within the enterprise, in which case identifiable costs incurred in developing the patents are capitalised. Patents are normally written off over their legal term of validity or over their working life, whichever is shorter.

### Know How

Know-how in general is recorded in the books only when some consideration in money or money's worth has been paid for it. Know-how is generally of two types: Relating to manufacturing processes and Relating to plans, designs and drawings of buildings or plant and machinery.

Know-how related to plans, designs and drawings of buildings or plant and machinery is capitalised under the relevant asset heads. In such cases depreciation is calculated on the total cost of those assets, including the cost of the know-how capitalised. Know-how related to manufacturing processes is usually expensed in the year in which it is incurred.

### Disclosure

- i. Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements;
- ii. Expenditure incurred on account of fixed assets in the course of construction or acquisition; and
- iii. Revalued amounts substituted for historical costs of fixed assets, the method adopted to compute the revalued amounts, the nature of any indices used, the year of any appraisal made, and whether an external valuer was involved, in case where fixed assets are stated at revalued amounts.

### Example

On March 01, 2006, X Ltd. purchased Rs. 5 lakhs worth of land for a factory site. Company demolished an old building on the property and sold the material for Rs. 10,000. Company incurred additional cost and realized salvaged proceeds during the March 2006 as follows:



Legal fees for purchase contract and recording ownership	Rs. 25,000
Title guarantee insurance	Rs. 10,000
Cost for demolition of building	Rs. 30,000

In March 31, 2006 balance sheet, X Ltd. should report a balance in the land account.

Solution

<u>Calculation of the cost for Purchase of Land</u>		
Particulars		Rs.
Cost of Land		500,000
Legal Fees		25,000
Title Insurance		10,000
Cost of Demolition	50,000	
Less: Salvage value of Material	<u>10,000</u>	<u>40,000</u>
Cost of the Asset		<u>575,000</u>

#### 9.10 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:

- In accounting for transactions in foreign currencies.
- In translating the financial statements of foreign operations.
- This Statement also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.

This Statement does not:

- Specify the currency in which an enterprise presents its financial statements.
- 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.
- 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

<u>Journals in the Books of Kalim Ltd.</u>			
Date	Particulars	Rs. (Dr.)	Rs. (Cr.)
Jan. 01, 2006	Bank Account Dr. (4,50,000 x 48)	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.

#### Change in the Classification of a 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.

#### Example

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





Accounting Standards

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 (Recorded in HO books as Rs. 4,02,000)	6,100	
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 trail 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:

Trail Balance of the Foreign Branch converted into Indian Ruppes as on March 31, 2008					
Particulars	£ (Dr.)	£ (Cr.)	Coverion Basis	Rs. (Dr.)	Rs. (Cr.)
			Transaction Date		
Fixed Assets	5,000		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	



## Advanced Accounting

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		
	<u>31,400</u>	<u>31,400</u>	<u>2,037,800</u>	<u>2,058,000</u>
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 01<sup>st</sup> 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 01<sup>st</sup> 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	<u>Rs. 48.85</u>
Premium on Contract	<u>Rs. 0.30</u>



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  $(30,000/3) \times 2 = \text{Rs. } 20,000$ .

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 1<sup>st</sup> December at 1 US\$ = Rs. 47.10 when exchange rate was US\$ 1 = Rs. 47.02. On 31<sup>st</sup> December when he closed his books exchange rate was US\$ 1 = Rs. 47.15. On 31<sup>st</sup> 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	<u>Rs. 47.10</u>
Premium on Contract	<u>Rs. 0.08</u>
Contract Amount	US\$ 1,00,000
Total Profit (1,00,000 x 0.08)	Rs. 8,000

Disclosure

An enterprise should disclose:

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

### 9.11 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.	5,00,000	
	To Bank Account		5,00,000
	(Being Fixed Assets purchased)		
	Bank Account Dr.	1,00,000	
	To Deferred Govt. Grant Account		1,00,000
	(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	



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	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 fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet 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 2<sup>nd</sup> 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 2<sup>nd</sup> 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 recognised in the financial statements, including grants of non-monetary assets given at a concessional rate or free of cost.



### 9.12 ACCOUNTING FOR INVESTMENTS (AS 13)

This Accounting Standard comes into effect for financial statements covering periods commencing on or after April 1, 1995.

This Statement does not deal with:

- a. The bases for recognition of interest, dividends and rentals earned on investments which are covered by AS 9.
- b. Operating or finance leases.
- c. Investments of retirement benefit plans and life insurance enterprises and
- d. Mutual funds and/or the related asset management companies, banks and public financial institutions formed under a Central or State Government Act or so declared under the Companies Act, 1956.

*Fair value* is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction. Under appropriate circumstances, market value or net realisable value provides an evidence of fair value.

*Market value* is the amount obtainable from the sale of an investment in an open market, net of expenses necessarily to be incurred on or before disposal.

#### Forms of Investments

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

Enterprises hold investments for diverse reasons. For some enterprises, investment activity is a significant element of operations, and assessment of the performance of the enterprise may largely, or solely, depend on the reported results of this activity.

Some investments have no physical existence and are represented merely by certificates or similar documents (e.g., shares) while others exist in a physical form (e.g., buildings).

For some investments, an active market exists from which a market value can be established. For other investments, an active market does not exist and other means are used to determine fair value.

#### Classification of Investments

A current investment is an investment that is by its nature readily realisable and is intended to be held for not more than one year from the date on which such investment is made.



A long term investment is an investment other than a current investment.

#### Cost of Investments

The cost of an investment includes acquisition charges such as brokerage, fees and duties.

If an investment is acquired, or partly acquired, by the issue of shares or other securities or another assets, the acquisition cost is the fair value of the securities issued or assets given up. The fair value may not necessarily be equal to the nominal or par value of the securities issued. It may be appropriate to consider the fair value of the investment acquired if it is more clearly evident.

Interest, dividends and rentals receivables in connection with an investment are generally regarded as income, being the return on the investment. However, in some circumstances, such inflows represent a recovery of cost and do not form part of income.

If it is difficult to make such an allocation except on an arbitrary basis, the cost of investment is normally reduced by dividends receivable only if they clearly represent a recovery of a part of the cost.

When right shares offered are subscribed for, the cost of the right shares is added to the carrying amount of the original holding. If rights are not subscribed for but are sold in the market, the sale proceeds are taken to the profit and loss statement. However, where the investments are acquired on cum-right basis and the market value of investments immediately after their becoming ex-right is lower than the cost for which they were acquired, it may be appropriate to apply the sale proceeds of rights to reduce the carrying amount of such investments to the market value.

#### Carrying Amount of Investments

The carrying amount for current investments is the lower of cost and fair value. Valuation of current investments on overall basis is not considered appropriate. The more prudent and appropriate method is to carry investments individually at the lower of cost and fair value. Any reduction to fair value and any reversals of such reductions are included in the Profit & Loss Statement.

Long-term investments are usually carried at cost. Where there is a decline, other than temporary, in the carrying amounts of long term investments, the resultant reduction in the carrying amount is charged to the profit and loss statement. The reduction in carrying amount is reversed when there is a rise in the value of the investment, or if the reasons for the reduction no longer exist.

#### Investment Properties

An investment property is an investment in land or buildings that are not intended to be occupied substantially for use by, or in the operations of, the investing enterprise.



The cost of any shares in a co-operative society or a company, the holding of which is directly related to the right to hold the investment property, is added to the carrying amount of the investment property.

#### Disposal of Investments

On disposal of an investment, the difference between the carrying amount and the disposal proceeds, net of expenses, is recognised in the profit and loss statement.

When disposing of a part of the holding of an individual investment, the carrying amount to be allocated to that part is to be determined on the basis of the average carrying amount of the total holding of the investment.

#### Reclassification of Investments

Where long-term investments are reclassified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

Where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

#### Disclosure

The following disclosures in financial statements in relation to investments are appropriate: -

- a. The accounting policies for the determination of carrying amount of investments.
- b. The amounts included in profit and loss statement for:
  - i. Interest, dividends (showing separately dividends from subsidiary companies), and rentals on investments showing separately such income from long term and current investments. Gross income should be stated, the amount of income tax deducted at source being included under Advance Taxes Paid.
  - ii. Profits and losses on disposal of current investments and changes in carrying amount of such investments.
  - iii. Profits and losses on disposal of long term investments and changes in the carrying amount of such investments.
- c. Significant restrictions on the right of ownership, realisability of investments or the remittance of income and proceeds of disposal.
- d. The aggregate amount of quoted and unquoted investments, giving the aggregate market value of quoted investments.
- e. Other disclosures as specifically required by the relevant statute governing the enterprise.



*Note: For problems based on practical application of AS 13, students are advised to refer unit 2 of Chapter 10*

### 9.13 ACCOUNTING STANDARD 14: ACCOUNTING FOR AMALGAMATIONS

This standard came into effect in respect of accounting periods commencing on or after 1.4.1995 and is mandatory in nature. It deals with accounting for amalgamations and the treatment of any resultant goodwill or reserves. This statement is directed principally to companies although some of its requirements also apply to financial statements of other enterprises.

This statement does not deal with cases of acquisitions. The distinguishing feature of an acquisition is that the acquired company is not dissolved and its separate entity continues to exist.

Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute which may be applicable to companies.

*Transferor company* means the company which is amalgamated into another company.

*Transferee company* means the company into which a transferor company is amalgamated.

#### Types of Amalgamations

Amalgamations fall into two broad categories. In the first category are those amalgamations where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies. These are known as Amalgamation in nature of merger. Other is known as Amalgamation in nature of purchase.

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

- i. All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- ii. Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- iii. The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company



is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.

- iv. The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- v. No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

Amalgamation in the nature of purchase is an amalgamation which does not satisfy any one or more of the conditions specified above.

#### Methods of Accounting for Amalgamations

There are two main methods of accounting for amalgamations the pooling of interests method and the purchase method.

#### Pooling of interests

Under this method, the assets, liabilities and reserves of the transferor company are recorded by the transferee company at their existing carrying amounts.

If, at the time of the amalgamation, the transferor and the transferee companies have conflicting accounting policies, a uniform set of accounting policies is adopted following the amalgamation. The effects on the financial statements of any changes in accounting policies are reported in accordance with AS 5.

#### The Purchase Method

Under the purchase method, the transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.

Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company.

Many amalgamations recognise that adjustments may have to be made to the consideration in the light of one or more future events. When the additional payment is probable and can reasonably be estimated at the date of amalgamation, it is included in the calculation of the consideration. In all other cases, the adjustment is recognised as soon as the amount is determinable [AS 4].



Example

A Ltd. take over B Ltd. on April 01, 2006 and discharges consideration for the business as follows:

- (i) Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.
- (ii) Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders (Rs. 1,70,000) of B Ltd. at a premium of 10%.
- (iii) It is agreed that the debentures of B Ltd. (Rs. 50,000) will be converted into equal number and amount of 13% debentures of A Ltd.

Solution:

Particulars	Rs.	Rs.
Equity Shares (42,000 x 10)		4,20,000
Preference Share Capital	1,70,000	
Add: Premium on Redemption	<u>17,000</u>	<u>1,87,000</u>
Purchase Consideration		<u>6,07,000</u>

Treatment of Reserves on Amalgamation

If the amalgamation is an 'amalgamation in the nature of merger', the identity of the reserves is preserved and they appear in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company. As a result of preserving the identity, reserves which are available for distribution as dividend before the amalgamation would also be available for distribution as dividend after the amalgamation. The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company is adjusted in reserves in the financial statements of the transferee company.

If the amalgamation is an 'amalgamation in the nature of purchase', the amount of the consideration is deducted from the value of the net assets of the transferor company acquired by the transferee company. If the result of the computation is negative, the difference is debited to goodwill arising on amalgamation and if the result of the computation is positive, the difference is credited to Capital Reserve.

In the case of an 'amalgamation in the nature of purchase', the balance of the Profit and Loss Account appearing in the financial statements of the transferor company, whether debit or credit, loses its identity.



Certain reserves may have been created by the transferor company pursuant to the requirements of certain acts, referred to hereinafter as 'statutory reserves'. Such reserves retain their identity in the financial statements of the transferee company in the same form in which they appeared in the financial statements of the transferor company, so long as their identity is required to be maintained to comply with the relevant statute. This exception is made only in those amalgamations where the requirements of the relevant statute for recording the statutory reserves in the books of the transferee company are complied with. In such cases the statutory reserves are recorded in the financial statements of the transferee company by a corresponding debit to a suitable account head (e.g., 'Amalgamation Adjustment Account') which is disclosed as a part of 'miscellaneous expenditure' or other similar category in the balance sheet. When the identity of the statutory reserves is no longer required to be maintained, both the reserves and the aforesaid account are reversed.

#### Treatment of Goodwill Arising on Amalgamation

Goodwill arising on amalgamation represents a payment made in anticipation of future income and it is appropriate to treat it as an asset to be amortised to income on a systematic basis over its useful life. Due to the nature of goodwill, it is frequently difficult to estimate its useful life with reasonable certainty. Such estimation is, therefore, made on a prudent basis. Accordingly, it is considered appropriate to amortise goodwill over a period not exceeding five years unless a somewhat longer period can be justified.

#### Illustration:

The following are the balance sheets of A Ltd. and B Ltd. as on March 31, 2006:

<i>Liabilities</i>	A Ltd. (Rs.)	B Ltd. (Rs.)
Equity Shares, Rs. 10 each, fully paid up	7,20,000	3,00,000
14% Preference Share Capital, Rs. 100 each, fully paid up	1,50,000	1,70,000
Securities Premium	1,50,000	
Capital Reserve		13,000
General Reserve	80,000	45,000
Export Profit Reserve		20,000
Profit and Loss Account	75,000	40,000
Workmen Compensation Fund		9,000
13% Debentures, Rs. 100 each, fully paid up	1,00,000	50,000
Creditors	1,15,000	35,000
Provision for Taxation	15,000	10,000
	<u>14,05,000</u>	<u>6,92,000</u>
<i>Assets</i>		
Goodwill	2,00,000	60,000
Land and Buildings	2,50,000	
Plant and Machinery	3,25,000	2,70,000





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Furniture and Fixtures	57,000	95,000
Stock	2,15,000	1,75,000
Debtors	72,000	30,000
Income Tax Refund Claim		6,000
Cash at Bank	2,16,000	50,000
Cash in Hand	70,000	
Preliminary Expenses		6,000
	<u>14,05,000</u>	<u>6,92,000</u>

A Ltd. take over B Ltd. on April 01, 2006 and discharges consideration for the business as follows:

- a. Issued 42,000 fully paid equity shares of Rs. 10 each at par to the equity shareholders of B Ltd.
- b. Issued fully paid up 15% preference shares of Rs. 100 each to discharge the preference shareholders of B Ltd. at a premium of 10%.
- c. It is agreed that the debentures of B Ltd. will be converted into equal number and amount of 13% debentures of A Ltd.
- d. The Statutory Reserve of B Ltd. is to be maintained for two more years.
- e. Expenses of amalgamation amounting to Rs. 15,000 are borne by A Ltd.

**Solution:**

Since all the five conditions are satisfied, it is amalgamation in the nature of merger. Following are the journal entries in the books of A Ltd. and the calculation of the Purchase Consideration.

Particulars	Dr. (Rs.)	Cr. (Rs.)
Goodwill Account Dr.	60,000	
Plant & Machinery Account Dr.	270,000	
Furniture & Fixtures Account Dr.	95,000	
Stock Account Dr.	175,000	
Debtors Account Dr.	30,000	
IT Refund Account Dr.	6,000	
Bank Account Dr.	50,000	
Preliminary Expenses Account Dr.	6,000	



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General Reserve Account Dr. (Balancing Figure)	52,000	
To Capital Reserve Account		13,000
To Export Profit Reserve Account		20,000
To Workmen Compensation Fund Account		9,000
To 13% Debentures Account		50,000
To Creditors Account		35,000
To Provision for Tax Account		10,000
To Business Purchase Account		607,000
Business Purchase Account Dr.	607,000	
To B Ltd. Liquidator Account		607,000
B Ltd. Liquidator Account Dr.	607,000	
To Equity Share Capital Account		420,000
To Preference Share Capital		187,000
13% Debentures Account Dr. (In B Ltd.)	50,000	
To 13% Debentures Account (In A Ltd.)		50,000
General Reserve Account Dr.	15,000	
To Bank Account		15,000

If we consider that the fifth point i.e. business of B Ltd. was not carried on by A Ltd. then it will be Amalgamation in the nature of Purchase and the journal entries in the books of A Ltd. will be as follow:

Particulars	Dr. (Rs.)	Cr. (Rs.)
Goodwill Account Dr. (Balancing Figure)	76,000	
Plant & Machinery Account Dr.	270,000	
Furniture & Fixtures Account Dr.	95,000	

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Stock Account Dr.	175,000	
Debtors Account Dr.	30,000	
IT Refund Account Dr.	6,000	
Bank Account Dr.	50,000	
To 13% Debentures Account		50,000
To Creditors Account		35,000
To Provision for Tax Account		10,000
To Business Purchase Account		607,000
Business Purchase Account Dr.	607,000	
To B Ltd. Liquidator Account		607,000
B Ltd. Liquidator Account Dr.	607,000	
To Equity Share Capital Account		420,000
To Preference Share Capital		187,000
13% Debentures Account Dr. (In B Ltd.)	50,000	
To 13% Debentures Account (In A Ltd.)		50,000
Goodwill Account Dr.	15,000	
To Bank Account		15,000
Amalgamation Adjustment Account Dr.	20,000	
To Export Profit Reserve Account		20,000

Disclosure

For all amalgamations, the following disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Names and general nature of business of the amalgamating companies;
- b. Effective date of amalgamation for accounting purposes;



- c. The method of accounting used to reflect the amalgamation; and
- d. Particulars of the scheme sanctioned under a statute.

For amalgamations accounted for under the pooling of interests method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

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

For amalgamations accounted for under the purchase method, the following additional disclosures are considered appropriate in the first financial statements following the amalgamation:

- a. Consideration for the amalgamation and a description of the consideration paid or contingently payable; and
- b. The amount of any difference between the consideration and the value of net identifiable assets acquired, and the treatment thereof including the period of amortisation of any goodwill arising on amalgamation.

#### **9.15 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 <sup>2</sup> 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.

#### 9.16 ACCOUNTING FOR 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 =  $L_1, L_2 \dots \dots \dots L_n$  (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

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



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

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

$$\text{Fair Value} = \text{PV of Minimum Lease Payments} + \text{PV of unguaranteed residual value} \dots (1)$$

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 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
5	15,000	0.621	9,315
			<hr/> 2,14,340 <hr/>



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
			<u>1,92,360</u>

Interest rate implicit on lease is computed below by interpolation:

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

#### 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
			<u>1,91,500</u>

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:

Asset	Rs.	Rs.
	<u>1,91,500</u>	<u>1,91,500</u>
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	
	<u>2,75,000</u>	<u>83,500</u>	<u>1,91,500</u>	

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

Finance Charge	Rs.	Rs.
	<u>24,129</u>	<u>          </u>
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
			<u>2,05,025</u>

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:

Asset	Rs.	Rs.
	<u>2,00,000</u>	<u>2,00,000</u>
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
			<u>1,94,425</u>

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

Allocation of finance charge over lease period is shown below:

Year	Minimum Lease Payments Rs.	Finance Charge (10.95%) Rs.	Principal Rs.	Principal due 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	
	<u>2,75,000</u>	<u>75,000</u>	<u>2,00,000</u>	

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

Finance Charge	Rs. <u>21,900</u>	Rs. <u>21,900</u>
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 rate of interest implicit in the lease.

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

$$= (\text{GIL} - \text{Fair Value}) + (\text{Fair Value} - \text{Cost})$$

$$= \text{Unearned Finance Income} + (\text{Fair Value} - \text{Cost})$$

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:

Lease Rent	Rs.	Rs.
To Lessor	25,000	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.

$$\begin{aligned} \text{Total lease rent} &= 120\% \text{ of Rs. 5 lakh} \times \frac{\text{Output during lease period}}{\text{Total output}} \\ &= \text{Rs. 6 lakh} \times \frac{60,000 \text{ units}}{125,000 \text{ units}} = \text{Rs. 2.88 lakh} \end{aligned}$$

$$\text{Annual lease rent} = \text{Rs. 2,88,000} / 3 = \text{Rs. 96,000}$$

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:

	<u>Rs.</u>	<u>Rs.</u>
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.

### 9.17 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:

$$(1,800 \times 5/12) + (2,400 \times 5/12) + (2,100 \times 2/12) = 2,100 \text{ shares.}$$

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

$$(1,800 \times 12/12) + (600 \times 7/12) - (300 \times 2/12) = 2,100 \text{ shares}$$

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 2005	Rs. 18,00,000
Net profit for the year 2006	Rs. 60,00,000
No. of equity shares outstanding until 30th September 2006	20,00,000



Bonus issue 1st October 2006 was 2 equity shares for each equity share outstanding at 30th September, 2006

Calculate Basic Earnings Per Share.

**Solution:**

No. of Bonus Issue  $20,00,000 \times 2 = 40,00,000$  shares

Earnings per share for the year 2006  $\frac{\text{Rs. } 60,00,000}{(20,00,000 + 40,00,000)}$

= Re. 1.00

Adjusted earnings per share for the year 2005  $\frac{\text{Rs. } 18,00,000}{(20,00,000 + 40,00,000)}$

= 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 2005, 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 2005	Rs. 11,00,000
Net profit for the year 2006	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 2006



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 2006 was Rs. 21.00. Compute Basic Earnings Per Share.

**Solution:**

Fair value of shares immediately prior to exercise of rights + Total amount received from exercise  
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 2005 as originally reported: Rs. 11,00,000/5,00,000 shares = Rs. 2.20

EPS for the year 2005 restated for rights issue: Rs. 11,00,000/ (5,00,000 shares x 1.05) = Rs. 2.10

EPS for the year 2006 including effects of rights issue:

$$(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12) = 5,87,500 \text{ shares}$$

$$\text{EPS} = 15,00,000/5,87,500 = \text{Rs. } 2.55$$

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  $(1,00,00,000 + 12,00,000 - 3,60,000) = \text{Rs. } 1,08,40,000$

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:  $(1,08,40,000/60,00,000) = \text{Rs. } 1.81$

#### 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 2005	Rs. 12,00,000
Weighted average number of equity shares outstanding during the year 2005	5,00,000 shares
Average fair value of one equity share during the year 2005	Rs. 20.00
Weighted average number of shares under option during the year 2005	1,00,000 shares
Exercise price for shares under option during the year 2005	Rs. 15.00

Compute Basic and Diluted Earnings Per Share.

Solution:

Computation of earnings per share		
	Earnings Rs.	Shares Earnings/Share Rs.
Net profit for the year 2005	12,00,000	
Weighted average no. of shares during year 2005		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	<u>12,00,000</u>	<u>5,25,000</u> <u>2.29</u>

### 9.18 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:

- 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.
- 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.

#### 9.19 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 standard, 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**

The company deals in three products, A, B and C, which are neither similar nor interchangeable. At the time of closing of its account for the year 2005-06. The Historical Cost and Net Realizable Value of the items of closing stock are determined as follows:

Items	Historical Cost (Rs. in lakhs)	Net Value (Rs. in lakhs)	Realisable
A	40		28
B	32		32
C	16		24

What will be the value of Closing Stock?

#### **Solution**



As per para 5 of AS 2 on Valuation of Inventories, inventories should be valued at the lower of cost and net realizable value. Inventories should be written down to net realizable value on an item-by-item basis in the given case.

Items	Historical Cost (Rs. in lakhs)	Net Realisable Value (Rs. in lakhs)	Valuation of closing stock (Rs. in lakhs)
A	40	28	28
B	32	32	32
C	<u>16</u>	<u>24</u>	<u>16</u>
	<u>88</u>	<u>84</u>	<u>76</u>

Hence, closing stock will be valued at Rs. 76 lakhs.

### Illustration 2

During the current year 2005–2006, X Limited made the following expenditure relating to its plant building:

	Rs. In lakhs
Routine Repairs	4
Repairing	1
Partial replacement of roof tiles	0.5
Substantial improvements to the electrical wiring system which will increase efficiency	10

What amount should be capitalized?

### Solution

As per para 12.1 of AS 10 on Accounting for Fixed Assets, expenditure that increases the future benefits from the existing asset beyond its previously assessed standard of performance is included in the gross book value, e.g., an increase in capacity. Hence, in the given case, Repairs amounting Rs. 5 lakhs and Partial replacement of roof tiles should be charged to profit and loss statement. Rs. 10 lakhs incurred for substantial improvement to the electrical writing system which will increase efficiency should be capitalized.

### Illustration 3

A plant was depreciated under two different methods as under:

Year	SLM (Rs. in lakhs)	W.D.V. (Rs. in lakhs)
1	7.80	21.38



2	7.80	15.80
3	7.80	11.68
4	<u>7.80</u>	<u>8.64</u>
	<u>31.20</u>	<u>57.50</u>
5	7.80	6.38

What should be the amount of resultant surplus/deficiency, if the company decides to switch over from W.D.V. method to SLM method for first four years? Also state, how will you treat the same in Accounts.

#### Solution

As per para 21 of AS 6 on Depreciation Accounting, when a change in the method of depreciation is made, depreciation should be recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recomputation of depreciation in accordance with the new method should be adjusted in the accounts in the year in which the method of depreciation is changed. In the given case, there is a surplus of Rs. 26.30 lakhs on account of change in method of depreciation, which will be credited to Profit and Loss Account. Such a change should be treated as a change in accounting policy and its effect should be quantified and disclosed.

#### Illustration 4

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 31.3.2006 was 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 asset 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 5**

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

\* On the basis that machinery is ready for its intended use at the time of its acquisition/purchase.



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.

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 6

How would you deal with the following in the annual accounts of a company for the year ended 31st march, 2006 ?

- (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. Upto 2004-05, 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 2004-05. 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, 2000 to September, 2004 has been received and paid in February, 2005.
- (c) The Board of Directors decided on 31.3.2006 to increase the sale price of certain items retrospectively from 1st January, 2006.

In view of this price revision with effect from 1st January, 2006, the company has to receive Rs. 15 lakhs from its customers in respect of sales made from 1st January, 2006 to 31st March, 2006 and the Accountant cannot make up his mind whether to include Rs. 15 lakhs in the sales for 2005-06.





**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, 2005 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2005. 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 2005, this material charge has arisen in the current period i.e., year ended 31st March, 2006. 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.

- (c) Price revision was effected during the current accounting period 2005-2006. As a result, the company stands to receive Rs. 15 lakhs from its customers in respect of sales made



from 1st January, 2006 to 31st March, 2006. If the company is able to assess the ultimate collection with reasonable certainty, then additional revenue arising out of the said price revision may be recognised in 2005-96 vide Para 10 of AS 9.

**Illustration 7**

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2006.

	(Rs. in lakhs)
Total Contract Price	1,000
Work Certified	500
Work not Certified	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

The firm seeks your advice and assistance in the presentation of accounts keeping in view the requirements of AS 7 (Revised) issued by your institute.

**Solution**

(a) Amount of foreseeable loss	(Rs in lakhs)
Total cost of construction (500 + 105 + 495)	1,100
Less: Total contract price	<u>1,000</u>
Total foreseeable loss to be recognized as expense	<u>100</u>

According to para 35 of AS 7 (Revised 2002), when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

(b) Contract work-in-progress i.e. cost incurred to date are Rs. 605 lakhs	(Rs in lakhs)
Work certified	500
Work not certified	<u>105</u>
	<u>605</u>

This is 55% ( $605/1,100 \times 100$ ) of total costs of construction.



- (c) Proportion of total contract value recognised as revenue as per para 21 of AS 7 (Revised).

55% of Rs. 1,000 lakhs = Rs. 550 lakhs

- (d) Amount due from/to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)
- = [605 + Nil – 100 – (400 + 140)] Rs. in lakhs
- = [605 – 100 – 540] Rs. in lakhs

Amount due to customers = Rs. 35 lakhs

The amount of Rs. 35 lakhs will be shown in the balance sheet as liability.

- (e) The relevant disclosures under AS 7 (Revised) are given below:

	<u>Rs. in lakhs</u>
Contract revenue	550
Contract expenses	605
Recognised profits less recognized losses	(100)
Progress billings (400 + 140)	540
Retentions (billed but not received from contractee)	140
Gross amount due to customers	35

### Illustration 8

In preparing the financial statements of R Ltd. for the year ended 31st March, 2006, you come across the following information. State with reasons, how you would deal with them in the financial statements:

- (a) An unquoted long term investment is carried in the books at a cost of Rs. 2 lakhs. The published accounts of the unlisted company received in May, 2006 showed that the company was incurring cash losses with declining market share and the long term investment may not fetch more than Rs. 20,000.
- (b) The company invested 100 lakhs in April, 2006 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, 2006 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.

- (a) Investments classified as long term investments should be carried in the financial statements at 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. Para 17 of AS 13 'Accounting for Investments' states that indicators of the value of an investment are obtained by reference to its market value, the investee's assets and results and the expected cash flows from the investment. On these bases, the facts of the given case clearly suggest that the provision for diminution should be made to reduce the carrying amount of long term investment to Rs. 20,000 in the financial statements for the year ended 31st March, 2006.
- (b) 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, 2006. 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, 2006 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 9

- (a) A Limited Company closed its accounting year on 30.6.05 and the accounts for that period were considered and approved by the board of directors on 20th August, 2005. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2005 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 30.6.05.
- (b) Y Co. Ltd., used certain resources of X Co. Ltd. In return X Co. Ltd. received Rs. 10 lakhs and Rs. 15 lakhs as interest and royalties respective from Y Co. Ltd. during the year 2005-06.  
You are required to state whether and on what basis these revenues can be recognised by X Co. Ltd.
- (c) A Ltd. purchased fixed assets costing Rs. 3,000 lakhs on 1.1.2005 and the same was fully financed by foreign currency loan (U.S. Dollars) payable in three annual equal instalments. Exchange rates were 1 Dollar = Rs. 40.00 and Rs. 42.50 as on 1.1.2005



and 31.12.2005 respectively. First instalment was paid on 31.12.2005. The entire difference in foreign exchange has been capitalized.

You are required to state, how these transactions would be accounted for.

### 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.

- (b) As per para 13 of AS 9 on Revenue Recognition, revenue arising from the use by others of enterprise resources yielding interest and royalties should only be recognised when no significant uncertainty as to measurability or collectability exists. These revenues are recognised on the following bases:
- (i) Interest: on a time proportion basis taking into account the amount outstanding and the rate applicable.
  - (ii) Royalties: on an accrual basis in accordance with the terms of the relevant agreement.
- (c) As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', 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 recognized as income or expenses in the period in which they arise. Thus exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets are recognized as income or expense.

Calculation of Exchange Difference:

$$\text{Foreign currency loan} = \frac{\text{Rs. 3,000 lakhs}}{\text{Rs. 40}} = 75 \text{ lakhs US Dollars}$$

$$\begin{aligned} \text{Exchange difference} &= 75 \text{ lakhs US Dollars} \times (42.50 - 40.00) \\ &= \text{Rs. 187.50 lakhs} \end{aligned}$$

(including exchange loss on payment of first instalment)

Therefore, entire loss due to exchange differences amounting Rs. 187.50 lakhs should be charged to profit and loss account for the year.



### Illustration 10

- (a) On 1st December, 2005, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for Rs. 85 lakhs. On 31st March, 2006 the company found that it had already spent Rs. 64,99,000 on the construction. Prudent estimate of additional cost for completion was Rs. 32,01,000. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2006 as per provisions of Accounting Standard 7 (Revised)?
- (b) While preparing its final accounts for the year ended 31st March, 2006 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2006 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, 2006 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, 2006?

### Solution

	Rs.
(a)	
Cost incurred till 31 <sup>st</sup> March, 2006	64,99,000
Prudent estimate of additional cost for completion	<u>32,01,000</u>
Total cost of construction	97,00,000
Less: Contract price	<u>85,00,000</u>
Total foreseeable loss	<u>12,00,000</u>

According to para 35 of AS 7 (Revised 2002), the amount of Rs. 12,00,000 is required to be recognized as an expense.

$$\text{Contract work in progress} = \frac{\text{Rs. } 64,99,000 \times 100}{97,00,000} = 67\%$$

Proportion of total contract value recognized as turnover as per para 21 of AS 7 (Revised) on Construction Contracts.

$$= 67\% \text{ of Rs. } 85,00,000 = \text{Rs. } 56,95,000.$$

- (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 31<sup>st</sup> March, 2006. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31<sup>st</sup> March, 2006, then mere disclosure required as per para 15, would have been sufficient.

### Illustration 11

At the end of the financial year ending on 31<sup>st</sup> December, 2003, 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:
- There is a present obligation arising out of past events but not recognized as provision.
  - 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:

$$\begin{aligned} \text{Expected loss in next ten cases} &= 30\% \text{ of Rs. } 1,20,000 + 10\% \text{ of Rs. } 2,00,000 \\ &= \text{Rs. } 36,000 + \text{Rs. } 20,000 \\ &= \text{Rs. } 56,000 \end{aligned}$$

$$\begin{aligned} \text{Expected loss in remaining five cases} &= 30\% \text{ of Rs. } 1,00,000 + 20\% \text{ of Rs. } 2,10,000 \\ &= \text{Rs. } 30,000 + \text{Rs. } 42,000 \\ &= \text{Rs. } 72,000 \end{aligned}$$

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 12

X Co. Ltd. supplied the following information. You are required to compute the basic earning per share:

(Accounting year 1.1.2005 – 31.12.2005)

Net Profit	:	Year 2002 : Rs. 20,00,000
	:	Year 2003 : 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 – 31.3.2003.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2006	: Rs. 25

**Solution**

Computation of Basic Earnings Per Share  
(as per paragraphs 10 and 26 of AS 20 on Earnings Per Share)

	Year 2002 Rs.	Year 2003 Rs.
EPS for the year 2005 as originally reported		
= $\frac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (Rs. 20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 2005 restated for rights issue		
= [Rs. 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
EPS for the year 2006 including effects of rights issue		
Rs. 30,00,000		
$\frac{\text{Rs. 30,00,000}}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$		
11,97,500 shares		2.51 (approx.)

**Working Notes:**

## 1. Computation of theoretical ex-rights fair value per share

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

$$= \frac{(\text{Rs. } 25 \times 10,00,000 \text{ shares}) + (\text{Rs. } 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}}$$

\* Refer working note 2.



$$= \frac{\text{Rs. } 3,00,00,000}{12,50,000 \text{ shares}} = \text{Rs. } 24$$

2. Computation of adjustment factor

$$= \frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex - rights value per share}}$$
$$= \frac{\text{Rs. } 25}{\text{Rs. } 24 \text{ (Refer Working Note 1)}} = 1.04 \text{ (approx.)}$$

### Self- Examination Questions

#### I Objective type Questions

Choose the most appropriate answer from the given options:

- Which of the following does not form a part of contract costs as defined in AS 7 (Revised)?
  - Estimated warranty costs under the construction contract.
  - Comprehensive insurance policy premium for all open construction contracts.
  - Research and development costs incurred at the instance of the contractee and billed to his account.
  - General administration costs for which reimbursement is not specified in the contract.
- Capitalisation of borrowing costs should cease when
  - The borrowing is repaid in full.
  - The asset is fully complete.
  - Substantially all activities for putting the asset to use have been completed.
  - The asset is capitalized in the books.
- Investments classified as long-term investments should be carried in the financial statements at
  - Cost.
  - Fair value.
  - Lower of cost or fair value.
  - Face value.
- A change in accounting policy is justified
  - To comply with Accounting Standards.
  - To ensure more appropriate presentation of the financial statements.



- (c) To comply with the Law.
  - (d) All of the above.
5. AS 10 requires that the financial statements should disclose
- (a) Gross and net book values of fixed assets at the beginning and end of an accounting period showing additions, disposals, acquisitions and other movements.
  - (b) Expenditure incurred on account of fixed assets in the course of construction or acquisition.
  - (c) Revalued amounts substituted for historical costs along with the method adopted to compute the revalued amounts.
  - (d) All of the above.
6. Which one of the following best describes the reason for allocating a fixed asset's cost over its useful life?
- (a) To provide a better measure of the market value of the asset in the balance sheet.
  - (b) To match the cost of the asset with the revenue it is used to produce.
  - (c) To gradually bring the cost of the asset into income rather than to expense it all in the year of acquisition.
  - (d) To reduce income to take advantage of tax benefits of owning fixed assets.
7. 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.
8. 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.



9. The conversion of debt to equity
- (a) Must be shown on a notional basis as a financing cash flow.
  - (b) Must be shown on a notional basis as an investing cash flow.
  - (c) Under (a) or (b) as is appropriate.
  - (d) Must not be shown as it is a non-cash transaction.
10. 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.
11. Crown Ltd. wants to prepare its cash flow statement. It sold equipment of book value of Rs. 60,000 at a gain of Rs. 8,000. The amount to be reported in its cash flow statement under operating activities is
- (a) Nil.
  - (b) Rs. (8,000).
  - (c) Rs. 8,000.
  - (d) Rs. 68,000.
12. 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. (d), 2. (c), 3. (a), 4. (d), 5. (d), 6. (b), 7. (d), 8. (a), 9.(d), 10. (d), 11. (a), 12. (c)]

### II Short Answer Questions

13. Mention any five areas in which different accounting policies may be adopted by different enterprises.
14. What type of costs are excluded from the cost of inventory?
15. In the case of a manufacturing company:
16. List the items of inflows of cash receipts from operating activities in the case of a manufacturing company:
17. What are the disclosure requirements pertaining to events occurring after the balance sheet date?
18. When can an item qualify to be a prior period item?
19. Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.
20. Write short note on Effect of Uncertainties on Revenue Recognition.
21. Explain provisions contained in the Accounting Standard in respect of Revaluation of fixed assets.
22. 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 prior period item comment.
23. When can revenue be recognised in the case of transaction of sale of goods?
24. Write short note on valuation of fixed assets in special cases.
25. Describe the factors for determination of "Reportable Segments" as per AS 17.
26. Briefly describe the disclosure requirements for related party transactions as per Accounting Standard 18.
27. When Capitalisation of borrowing cost should cease as per Accounting Standard 16?
28. Define a "Business Segment" and a "Geographical Segment" as per Accounting Standard 17.
29. Write short note on Sale and Lease Back Transactions as per Accounting Standard 19.



30. Decide when research and development cost of a project can be deferred to future periods as per AS 26.
31. How is software acquired for internal use accounted for under AS-26?

### III Long Answer Questions

32. What are the main features of cash flow statement? Describe the classification of activities, as suggested in AS 3, to be used for preparing cash flow statement.
33. Explain the provisions of AS 5 regarding treatment of prior period items and extraordinary items.
34. State the different types of Leases contemplated in Accounting Standard 19 and discuss briefly.
35. How will you calculate "Diluted Earnings per Share" as per Accounting Standard 20? Explain in detail.
36. Describe the disclosure requirements for amalgamation including additional disclosure, if any, for different methods of amalgamation as per AS-14.
37. Explain recognition principles for contingent liabilities according to AS 29
38. Elucidate the classification of investments to determine the value of investments for the purpose of balance sheet.
39. How will you translate the financial statements of an integral foreign operation in accordance with AS 11(Revised)?

### IV Practical Problems

40. 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.
41. Raw material was purchased at Rs. 100 per kilo. Price of raw material is on the decline. The finished goods in which the raw material is incorporated is expected to be sold at below cost. 10,000 kgs. of raw material is on stock at the year end. Replacement cost is Rs. 80 per kg. State with reference to AS 2, how will you value the inventories ?
42. 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 – 2006 amounted to Rs. 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?

43. While preparing its final accounts for the year ended 31st March, 2002 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, 2002 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 ?

44. J Ltd. purchased machinery from K Ltd. on 30.09.2005. The price was Rs. 370.44 lakhs after charging 8% Sales-tax and giving a trade discount of 2% on the quoted price. Transport charges were 0.25% on the quoted price and installation charges come to 1% on the quoted price.

A loan of Rs. 300 lakhs was taken from the bank on which interest at 15% per annum was to be paid.

Expenditure incurred on the trial run was Materials Rs. 35,000, Wages Rs. 25,000 and Overheads Rs. 15,000.

Machinery was ready for use on 1.12.2005. However, it was actually put to use only on 1.5.2006. Find out the cost of the machine and suggest the accounting treatment for the expenses incurred in the interval between the dates 1.12.2005 to 1.5.2006. The entire loan amount remained unpaid on 1.5.2006.

45. 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.
46. 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.
47. Media Advertisers obtained advertisement rights for One Day World Cup Cricket Tournament to be held in May/June, 2006 for Rs. 250 lakhs. By 31st March, 2006 they have paid Rs. 150 lakhs to secure these advertisement rights.

The balance Rs. 100 lakhs was paid in April, 1999.



By 31st March, 2006 they procured advertisement for 70% of the available time for Rs. 350 lakhs. The advertisers paid 60% of the amount by that date. The balance 40% was received in April, 2006.

Advertisements for the balance 30% time were procured in April, 2006 for Rs. 150 lakhs.

The advertisers paid the full amount while booking the advertisement.

25% of the advertisement time is expected to be available in May, 2006 and the balance 75% in June, 2006.

You are asked to :

- (i) Pass journal entries in relation to the above.
- (ii) Show in columnar form as to how the items will appear in the monthly financial statements for March, April, May and June 2006.

Give reasons for your treatment.

48. X Co. Ltd. charged depreciation on its asset on SLM basis. For the year ended 31.3.2006 it changed to WDV basis. The impact of the change when computed from the date of the asset coming to use amounts to Rs. 20 lakhs being additional charge.

Decide how it must be disclosed in Profit and loss account. Also, discuss, when such changes in method of depreciation can be adopted by an enterprise as per AS-6.

49. 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, 2003:

(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.

Describe, how above will be dealt with in the account of the company for the year ended on 31.3.2006.

50. X Limited has recognized Rs. 10 lakhs on accrual basis income from dividend on units of mutual funds of the face value of Rs. 50 lakhs held by it as at the end of the financial year 31st March, 2006. The dividends on mutual funds were declared at the rate of 20% on 15th June, 2006. The dividend was proposed on 10th April, 2006 by the declaring company. Whether the treatment is as per the relevant Accounting Standard? You are asked to answer with reference to provisions of Accounting Standard.





# CHAPTER 3

## COMPANY ACCOUNTS

### UNIT – 1: PREPARATION OF FINANCIAL STATEMENTS

#### Learning Objectives

After studying this unit, you will be able to :

- ◆ Know, how to maintain books of account of a company
- ◆ Learn about statutory books of a company
- ◆ Prepare and present the final account of a company in a proper format
- ◆ Calculate managerial remuneration of managers in a company
- ◆ Appreciate the term divisible profit.

#### 1.1 MEANING OF COMPANY

The word 'company' derived from the Latin word '*com*' i.e. with or together and '*panis*' i.e. bread. Originally the word referred to an association of persons or merchant men discussing matters and taking food together. It denotes a group of persons and the effect of registration under the Companies Act is that such group becomes a corporate body having perpetual succession and a common seal. The term 'company' is defined in Section 2(10). The definition only says that a company means a company as defined in Section 3 of the Companies Act. Section 3 further explains the meaning of expression 'company', 'existing company', 'private company' and 'public company'. Apart from these categories, the different kinds of company are holding company, subsidiary company, foreign company and companies which are limited by guarantee and lastly an unlimited company. All these have already been discussed in the Common Proficiency Test Study Material. For their understanding, students can refer it.

#### 1.2 MAINTENANCE OF BOOKS OF ACCOUNT

Section 209 of the Companies Act states that books of account shall be maintained at the company's registered office unless the Board of Directors decide to keep them at another place in India. It is a duty of the company to inform the Registrar of Companies within seven days of the decision in case the Board of Directors decides to maintain books at the place other than the registered office.



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Where the company has a branch office, whether in or outside India the proper books of accounts relating to the transactions effected at the branch office are kept at that office and proper summarised returns made up to date at intervals of not more than three months are prepared and sent within reasonable time to head office.

Every company is required to keep proper books of account showing (i) all monies received and spent and the details thereof, (ii) sales and purchases of goods, and (iii) assets and liabilities. A company engaged in production, processing, manufacturing or mining activities has also to maintain, if required by the Central Government, cost accounting records *i.e.*, particulars relating to utilisation of material, labour and other items of costs.

Proper books of accounts shall not be deemed to be kept if there are not kept such books as are necessary to give a *true and fair view* of the state of affairs of the company or branch office, as the case may be, and to explain its transactions. Also if such books are not kept on *accrual basis* and according to system of double entry book keeping, proper books of accounts shall not be deemed to have been kept.

### 1.3 STATUTORY BOOKS

The following statutory books are required to be maintained by a company under different sections of the Companies Act :

- ◆ Register of Investments of the company not held in its own name (Section 49).
- ◆ Register of Mortgages and Charges (Section 143).
- ◆ Register of Members and Index (Sections 150 & 151).
- ◆ Register of Debenture-holders and Index (Section 152).
- ◆ Foreign Register of Members and of Debenture-holders and their duplicates (Sections 157 and 158).
- ◆ Minute Books (Section 193).
- ◆ Register of Contracts, Companies, and firms in which directors are interested (Section 301).
- ◆ Register of directors, managing director, manager and secretary (Section 303).
- ◆ Register of Directors' share-holding (Section 307).
- ◆ Register of investments in securities of any other body corporate, loans made, guarantees given or securities provided to any body corporate.

In addition, a company usually maintains a number of statistical books to keep a record of its transactions which have resulted either in the payment of money to it or constitute the basis on which certain payments have been made by it. Registers and documents relating to the issue of shares are :

- (i) Share Application and Allotment Book ;
- (ii) Share Call Book ; and
- (iii) Certificate Book.



In respect of shares, the company, in addition to maintain Register of Members, which it has to maintain statutorily, it also maintains (a) Share Transfer Book ; and (b) Dividend Register.

#### 1.4 ANNUAL RETURN

Under Section 149 of the Companies Act, every company having a share capital, shall within sixty days from the day of which each of the annual general meeting is held, prepare and file with the Registrar the annual return containing the particulars specified in Part I of Schedule V. The annual return shall be in the Form set out of Part II of Schedule V or near thereto as circumstances meet.

#### 1.5 FINAL ACCOUNTS

Under Section 210 of the Companies Act, at the annual general meeting of a company, the Board of Directors of the company shall lay before the company:

- (a) a balance sheet as at the end of the period;
- (b) a profit & loss account for that period.

In case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its annual general meeting instead of profit and loss account.

Every balance-sheet of the company shall give a true and fair view of the state of affairs of the company as at the end of the financial year and shall subject to the provisions of the section be in the Form set out in Part I of Schedule VI, or as near thereto as circumstances admit. Any insurance or banking company or any company engaged in generation or supply of electricity or any other class of company for which a Form of balance sheet has been prescribed under the Act governing such class of company need not follow such form (Section 211). Every Profit and Loss Account of a company shall also give a true and fair view of profit or loss of the company for the financial year and shall comply with the requirements of Part II of Schedule VI. Every insurance or banking company or any company engaged in the generation of electricity or any other class of company for which a Form of Profit and Loss Account has been specified under the Act governing such class of company need not follow the Form given in the Schedule VI to this Act.

While preparing the final accounts of a company the following should be kept in mind :

- \* Requirements of Schedule VI;
- \* Other statutory requirements;
- \* Accounting Standards issued by the Institute of Chartered Accountants of India on different accounting matters (AS-1 to AS-29);
- \* Statements and Guidance Notes issued by the Institute of Chartered Accountants of India;



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which are necessary for understanding the accounting treatment / valuation / disclosure suggested by the ICAI]

Recently, the Companies (Amendment) Act, 1999 which shall be deemed to have come into force on 31st day of October, 1998, has made the compliance of accounting standards mandatory by adding Sub-sections 3A, 3B and 3C in Section 211.

These are :

'(3A) Every profit and loss account and balance sheet of the company shall comply with the accounting standards.

(3B) Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss account and balance sheet, the following, namely :

- (a) the deviation from the accounting standards;
- (b) the reasons for such deviation; and
- (c) the financial effect, if any, arising due to such deviation.

(3C) For the purposes of this section, the expression "accounting standards" means the standards of accounting recommended by the Institute of Chartered Accountants of India constituted under the Chartered Accountants Act, 1949, as may be prescribed by the Central Government in consultation with the National Advisory Committee on Accounting Standards established under Sub-section (1) of Section 210A :

Provided that the standard of accounting specified by the Institute of Chartered Accountants of India shall be deemed to be the Accounting Standards until the Accounting Standards are prescribed by the Central Government under this sub-section'.

[Thus, until the National Advisory Committee on Accounting Standards is established, companies will be required to prepare their profit and loss account and balance sheet in respect of accounting years closing on or after October 31, 1998, in accordance with the Accounting Standards specified by the Institute {excluding recommendatory accounting standard(s)}- as notified by the ICAI in Journal of the ICAI, January 1999]

The balance sheet can be prepared either in Horizontal Form or in Vertical Form. However, there is no specified Form of Profit and Loss Account. Schedule VI - Part II gives only requirements as to Profit and Loss Account. Part III of Schedule VI gives interpretation. Students are advised to refer 'Part-1 Form of Balance Sheet' of Schedule VI from the latest Companies Act, for better understanding and presentation of Companies' Balance Sheet. While 'General Instructions for Preparation of Balance Sheet' and other relevant Forms given in Schedule VI and the requirements have been produced on the following pages.



## NOTES

### *General instructions for preparation of balance sheet*

- (a) The information required to be given under any of the items or sub-items in this Form, if it cannot be conveniently included in the balance sheet itself, shall be furnished in a separate Schedule to be annexed to and to form part of the balance sheet. This is recommended when items are numerous.
- (b) Naye Paise can also be given in addition to Rupees, if desired.
- (c) In the case of [subsidiary companies] the number of shares held by the holding company as well as by the ultimate holding company and its subsidiaries must be separately stated.  

The auditor is not required to certify the correctness of such shareholdings as certified by the management.
- (cc) The item "Share Premium Account" shall include details of its utilisation in the manner provided in section 78 in the year of utilisation.
- (d) Short-term loans will include those which are due for not more than one year as at the date of the balance sheet.
- (e) Depreciation written off or provided shall be allocated under the different assets heads and deducted in arriving at the value of fixed assets.
- (f) Dividends declared by subsidiary companies after the date of the balance sheet should not be included unless they are in respect of period which closed on or before the date of the balance sheet.
- (g) Any reference to benefits expected from contracts to the extent not executed shall not be made in the balance sheet but shall be made in the Board's report.
- (h) The debit balance in the Profit and Loss Account shall be shown as a deduction from the uncommitted reserves, if any.
- (i) As regards Loans and Advances, [the amount due from other companies under the same management within the meaning of sub-section (1B) of section 370 should also be given with the names of the companies] the maximum amount due from every one of these at any time during the year must be shown.
- (j) Particulars of any redeemed debentures which the company has power to issue should be given.



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- (k) Where any of the company's debentures are held by a nominee or a trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated.
- (l) A statement of investments [whether shown under "Investment" or under "Current Assets", as stock-in-trade] separately classifying trade investments and other investments should be annexed to the balance sheet, showing the names of the bodies corporate (indicating separately the names of the bodies corporate under the same management) in whose shares or debentures, investments have been made (including all investments, whether existing or not, made subsequent to the date as at which the previous balance sheet was made out) and the nature and extent of the investment so made in each such body corporate; provided that in the case of an investment company, that is to say, a company whose principal business is the acquisition of shares, stock, debentures or other securities, it shall be sufficient if the statement shows only the investments existing on the date as at which the balance sheet has been made out. In regard to the investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner), shall be given in the statement.
- (m) If, in the opinion of the Board, any of the current assets, loans and advances have not a value on realisation in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion shall be stated.
- (n) Except in the case of the first balance sheet laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the balance sheet shall be also given in the balance sheet. The requirement in this behalf shall, in the case of companies preparing quarterly or half-yearly accounts, etc., relate to the balance sheet for the corresponding date in the previous year.
- (o) The amounts to be shown under Sundry Debtors shall include the amounts due in respect of goods sold or services rendered or in respect of other contractual obligations but shall not include the amounts which are in the nature of loans or advances.
- (p) Current accounts with directors, and manager, whether they are in credit, or debit, shall be shown separately.



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### B. Vertical Form

*Name of the Company.....*

*Balance Sheet as at.....*

		<i>Schedule</i>	<i>Figures as at</i>	<i>Figures as</i>
		<i>No.</i>	<i>the end of</i>	<i>at the end of</i>
			<i>current</i>	<i>previous</i>
			<i>financial year</i>	<i>financial year</i>
1	2	3	4	5

#### I. Sources of Funds

(1) Shareholders' funds :

- (a) Capital
- (b) Reserves and surplus

(2) Loan funds :

- (a) Secured loans
- (b) Unsecured loans

TOTAL

#### II. Application of Funds

(1) Fixed assets :

- (a) Gross block
- (b) Less: depreciation
- (c) Net block
- (d) Capital work in progress

(2) Investments

(3) Current assets, loans and advances:

- (a) Inventories
- (b) Sundry debtors
- (c) Cash and bank balances
- (d) Other current assets





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- (e) Loans and advances
  - Less: Current liabilities and provisions:
    - (a) Liabilities
    - (b) Provisions
  - Net current assets
- (4) (a) Miscellaneous expenditure to the extent not written off or adjusted
  - (b) Profit and loss account

TOTAL

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### Notes :

1. Details under each of the above items shall be given in separate Schedules. The Schedules shall incorporate all the information required to be given under A — Horizontal Form read with notes containing general instructions for preparation of balance sheet.
  2. The Schedules, referred to above, accounting policies and explanatory notes that may be attached shall form an integral part of the balance sheet.
  3. The figures in the balance sheet may be rounded off to nearest '000' or '00' as may be convenient or may be expressed in terms of decimals of thousands.
  4. A footnote to the balance sheet may be added to show separately contingent liabilities.
- Amendments in Schedule VI to the Companies Act, 1956

### **Notification No. GSR 129(E), dated 22-2-1999, issued by the department of Company Affairs, Ministry of Law, Justice & Company Affairs**

In exercise of the powers conferred by sub-section (1) of section 641 of the Companies Act, 1956 (1 of 1956), the Central Government hereby makes the following further alterations in Schedule VI to the said Act, namely :-

In the said Schedule, in "Part I - Form of Balance Sheet", -

- (1) in the first column relating to "Instructions in accordance with which Liabilities should be made out", after the first paragraph appearing against the sub-heading "current liabilities and provisions", occurring in the second column, the following paragraph shall be inserted, namely:—



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"The name(s) of the small scale industrial undertaking(s) to whom the Company owe a sum exceeding Rs. 1 lakh which is outstanding for more than 30 days, are to be disclosed."

(2) in the second column, relating to "Liabilities", under the heading "current liabilities and provisions", after item (2), the following sub-items shall be inserted, namely:—

"(i) Total outstanding Dues of small scale industrial undertaking(s); and

(ii) Total outstanding Dues of creditors other than small scale industrial undertaking(s);

(3) in the "Notes" embodying General Instructions for preparation of balance sheet, after item (p), the following shall be inserted, namely:-

(q) A small scale industrial undertaking has the same meaning as assigned to it under clause (j) of section 3 of the Industries (Development and Regulation) Act, 1951."

### *Proforma of Profit and Loss Account*

Name of the Company.....

Profit and Loss Account for the Year Ended.....

	<i>Schedule No.</i>	<i>Figures as at the end of current financial year</i>	<i>Figures as at the end of previous financial year</i>
1	2	3	4
Income			
Sales			
Other Income			
Expenditure			
Purchases			
Manufacturing and other expenses			
Depreciation			
Interest and other Financial Charges			
Profit for the financial year before tax			
Provision for taxation			
Profit for the financial year after tax			



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Balance of profit and  
loss account brought forward  
Proposed dividend  
Transfers to reserves  
Balance carried to Balance sheet

### Notes:

1. Separate schedules should be annexed wherever required and would form a part of the Profit and Loss Account.
2. The figures in the profit and loss account may be rounded off to the nearest '000' or '00' as may be convenient or may be expressed in terms of decimals of thousands.
3. Footnotes may be appended to show the director's fees, managers and auditors remuneration, contingent liabilities not provided for etc.

### Part II

#### Requirements As To Profit And Loss Account

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to the modification of references as specified in that sub-section.
2. The profit and loss account—
  - (a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account; and
  - (b) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.
3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most convenient heads; and in particular, shall disclose the following information in respect of the period covered by the account :
  - (i) (a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales in respect of each class of goods dealt



with by the company, and indicating the quantities of such sales for each class separately.

- (b) Commission paid to sole selling agents within the meaning of section 294 of the Act.
  - (c) Commission paid to other selling agents.
  - (d) Brokerage and discount on sales, other than the usual trade discount.
- (ii) (a) In the case of manufacturing companies,—
- (1) The value of the raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under suitable headings without mentioning the quantities, provided all those items which in value individually account for 10% or more the total value of the raw material consumed shall be shown as separate and distinct items with quantities thereof in the break-up.
  - (2) (a) The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.
  - (b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.
  - (c) In the case of companies rendering or supplying services, the gross income derived from services rendered or supplied.
  - (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.
  - (e) In the case of other companies, the gross income derived under different heads.

**Note 1 :** The quantities of raw materials, purchases, stocks and the turnover, shall be expressed in quantitative denominations in which these are normally purchased or sold in the market.



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**Note 2 :** For the purpose of items (ii)(a), (ii)(b), and (ii)(d), the items for which the company is holding separate industrial licences, shall be treated as separate classes of goods, but where a company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class. In the case of trading companies, the imported items shall be classified in accordance with the classification adopted by the Chief Controller of Imports and Exports in granting the import licences.

**Note 3 :** In giving the break-up of purchases, stocks and turnover, items like spare parts and accessories, the list of which is too large to be included in the break-up, may be grouped under suitable headings without quantities, provided all those items, which in value individually account for 10% or more of the total value of the purchases, stocks, or turnover, as the case may be, are shown as separate and distinct items with quantities thereof in the break-up.

- (iii) In the case of all concerns having works in progress, the amounts for which such works have been completed at the commencement and at the end of the accounting period.
- (iv) The amount provided for depreciation, renewals or diminution in value of fixed assets.

If such provision is not made by means of a depreciation charge, the method adopted for making such provision.

If no provision is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of a note.

- (v) The amount of interest on the company's debentures and other fixed loans, that is to say, loans for fixed periods, stating separately the amount of interest, if any, paid or payable to the managing director and the manager, if any.
- (vi) The amount of charge for Indian income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation.
- (vii) The amount reserved for—
  - (a) repayment of share capital; and



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- (b) repayment of loans.
- (viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up.
  - (b) The aggregate, if material, of any amounts withdrawn from such reserves.
- (ix) (a) The aggregate, if material, of any amounts set aside to provisions made for meeting specific liabilities, contingencies or commitments.
  - (b) The aggregate, if material, of the amounts withdrawn from such provisions, as no longer required.
- (x) Expenditure incurred on each of the following items, separately for each item—
  - (a) Consumption of stores and spare parts.
  - (b) Power and fuel.
  - (c) Rent.
  - (d) Repairs to buildings.
  - (e) Repairs to machinery.
  - (f) (1) Salaries, wages and bonus.
    - (2) Contribution to provident and other funds.
    - (3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve.

**Note [1]** - Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.

- (g) Insurance.
- (h) Rates and taxes, excluding taxes on income.
- (j) Miscellaneous expenses :

**Provided** that any item under which the expenses exceed 1 per cent of the total revenue of the company or Rs. 5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the Profit and Loss Account and shall not be combined with any other item to be shown under 'Miscellaneous expenses'.



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- (xi) (a) The amount of income from investments, distinguishing between trade investments and other investments.
- (b) Other income by way of interest, specifying the nature of the income.
- (c) The amount of income-tax deducted if the gross income is stated under sub-paragraphs (a) and (b) above.
- (xii) (a) Profit or losses on investments showing distinctly the extent of the profits or losses earned or incurred on account of membership of a partnership firm to the extent not adjusted from any previous provision or reserve.

**Note :** Information in respect of this item should also be given in the balance sheet under the relevant provision or reserve account.

(b) Profits or losses in respect of transactions of a kind, not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.

(c) Miscellaneous income.

(xiii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(xiv) The aggregate amount of the dividends paid, and proposed, and stating whether such amounts are subject to deduction of income-tax or not.

(xv) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.

4. The profit and loss account shall also contain or give by way of a note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors) or manager, if any, by the company, the subsidiaries of the company and any other person:—

- (i) managerial remuneration under section 198 of the Act paid (or payable) during the financial year to the directors (including managing directors), or manager, if any;
- (ii) omitted.
- (iii) omitted.
- (iv) omitted.
- (v) omitted.
- (vi) other allowances and commission including guarantee commission (details to be given);
- (vii) any other perquisites or benefits in cash or in kind (stating approximate money value where practicable);



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(viii) pensions, etc.,—

(a) pensions,

(b) gratuities,

(c) payments from provident funds, in excess of own subscriptions and interest thereon,

(d) compensation for loss of office.

(e) consideration in connection with retirement from office.

4A. The profit and loss account shall contain or give by way of a note a statement showing the computation of net profits in accordance with section 349 of the Act with relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors), or manager (if any).

4B. The profit and loss account shall further contain or give by way of a note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered—

(a) as auditor,

(b) as adviser, or in any other capacity, in respect of—

(i) taxation matters;

(ii) company law matters;

(iii) management services; and

(c) in any other manner.

4C. In the case of manufacturing companies, the profit and loss account shall also contain, by way of a note in respect of each class of goods manufactured, detailed quantitative information in regard to the following, namely :

(a) the licensed capacity (where licence is in force);

(b) the installed capacity; and

(c) the actual production.

**Note 1** : The licensed capacity and installed capacity of the company as on the last date of the year to which the profit and loss account relates, shall be mentioned against items (a) and (b) above respectively.





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**Note 2 :** Against item (c), the actual production in respect of the finished products meant for sale shall be mentioned. In cases where semi-processed products are also sold by the company, separate details thereof shall be given.

**Note 3 :** For the purposes of this paragraph, the items for which the company is holding separate industrial licences shall be treated as separate classes of goods but where a company has more than one industrial licence for production of the same item at different places or for expansion of the licensed capacity, the item covered by all such licences shall be treated as one class.

4D. The profit and loss account shall also contain by way of a note the following information, namely :

- (a) value of imports calculated on C.I.F. basis by the company during the financial year in respect of :
  - (i) raw materials;
  - (ii) components and spare parts;
  - (iii) capital goods;
- (b) expenditure in foreign currency during the financial year on account of royalty, know-how, professional consultation fees, interest, and other matters;
- (c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;
- (d) the amount remitted during the year in foreign currencies on account of dividends with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and year to which the dividends related;
- (e) earnings in foreign exchange classified under the following head, namely :
  - (i) export of goods calculated on F.O.B. basis;
  - (ii) royalty, know-how, professional and consultation fees;
  - (iii) interest and dividend;
  - (iv) other income, indicating the nature thereof.

5. The Central Government may direct that a company shall not be obligated to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading



stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.

6.(1) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amounts for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.

(2) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period which ended on the corresponding date of the previous year.

### **Part III**

#### **Interpretation**

7.(1) For the purpose of Parts I and II of this Schedule, unless the context otherwise requires—

(a) the expression “provision” shall, subject to sub-clause (2) of this clause, 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 of which the amount cannot be determined with substantial accuracy;

(b) the expression “reserve” shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) the expression “capital reserve” shall not include any amount regarded as free for distribution through the profit and loss account; and the expression “revenue reserve” shall mean any reserve other than a capital reserve;

and in this sub-clause the expression “liability” shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the commencement of this Act; 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 this Schedule as a reserve and not as a provision.



8. For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognised stock exchange, and the expression "unquoted investment" shall be construed accordingly.

#### **Part IV**

By Notification No. GSR 388(E), dated May, 15, 1995, the Central Government has inserted Part IV in the Schedule VI to the Act. The summarised disclosure requirements of the said Part are as under :

- (i) Registration Details.
  - (ii) Capital raised during the year of account.
  - (iii) Position of mobilisation and deployment of funds.
  - (iv) Performance of the company.
  - (v) Three principal products/services of the company (as per monetary terms) together with ITC codes of such products.

This amendment will take effect in respect of accounts closed on or after 16-5-95.

#### **1.6 Presentation of Final Accounts in a Summary Form**

It is another form in which final statements of account of companies are drawn up, which has become quite popular in recent years. According to this form figures of income and expenditure, assets and liabilities grouped under main heads are shown in the profit and loss account and the balance sheet and their details and other information requiring disclosure are also disclosed in summarised form. In consequence, the profit and loss accounts and balance sheets are not loaded with details. They are simple and intelligible. However, those who want to see the full details may be frustrated with the abridged form of accounts.

The advantages of this form of presentation are as follows :

- (a) the financial position of the company can be ascertained easily since it is not cluttered up by a mass of details.
- (b) the shareholders and other interested parties do not lose interest in the statement, since it is not necessary for them to go through a long statement spared over several pages to find out the actual financial position.
- (c) nevertheless any one interested in details may obtain detailed financial statement from the company.

Section 219(1) of the Companies Act, 1956 requires that a copy of every balance sheet (including the profit and loss account, the auditor's report, and every other document required by law to be



## Company Accounts

annexed or attached, as the case may be, to the balance sheet) is to be laid before a company in general meeting. The balance sheet and profit and loss account can be prepared in abridged Form for use of the members and others who do not need full statements.

Such abridged accounts are to be prepared as per Form 23AB of Companies (Central Government's) General Rules and Forms, 1956. The statement shall be approved by the Board of Directors and signed on behalf of them. The Form is given on the following pages.

[Form No. 23-AB]

(See rule 7A)

Statement Containing Salient Feature of Balance-Sheet and Profit and Loss Account etc.,

As per section 219(1)(b)(iv)

Form of Abridged Balance-Sheet

Name of the company.....

Abridged balance-sheet as at.....

<i>Particulars</i>	<i>Figures as at the end of</i>	
	<i>Current financial year</i>	<i>Previous financial year</i>
1. Sources of funds		
(1) Shareholders funds		
(a) Capital		
(i) Equity		
(ii) Preference		
(b) Reserves and surplus		
(i) Capital reserve		
(ii) Revenue reserve		
(iii) Revaluation reserve		
(iv) Surplus in profit and loss account		
(v) Share Premium Reserve		
(vi) Investment Allowance Reserve		



- (2) Loan funds
    - (a) Debentures (The amount of convertible/  
partly convertible debentures indicating the  
date of conversion)
    - (b) Public deposits
    - (c) Secured loans (other than debentures)
    - (d) Unsecured loans
- Total of (1) and (2) :

## **II. APPLICATION OF FUNDS**

- (1) Fixed assets
  - (a) Net block (Original cost less depreciation)
  - (b) Capital work in progress
- (2) Investments
  - (a) Government securities
  - (b) Investment in subsidiary companies
    - (i) Quoted
    - (ii) Unquoted
  - (c) Others
    - (i) Quoted
    - (ii) Unquoted
- (3) (i) Current assets, loans and advances
  - (a) Inventories
  - (b) Sundry debtors
  - (c) Cash and bank balances
  - (d) Other current assets
  - (e) Loans and advances
    - (i) To subsidiary companies



## Company Accounts

(ii) To others

Less :

(ii) Current liabilities and provisions

(a) Liabilities

(b) Provisions

Net current assets [(i) – (ii)]

(4) Miscellaneous expenditure to the extent not  
written off or adjusted

(5) Profit and Loss Account

Total of 1 to 5

### Abridged Profit and Loss Account for the year ending.....

<i>Particulars</i>	<i>Figures as at the end of</i>	
	<i>Current</i>	<i>Previous</i>
	<i>year</i>	<i>year</i>
I. Income		
- Sales/services rendered (Details to be given - separately as per annexure)		
- Dividend		
- Interest		
- Other income (See Note 5)		
Total		
II. Expenditure		
Cost of goods consumed/sold		
(i) Opening Stock		
(ii) Purchases		
<i>Less</i> : Closing stock		
Manufacturing expenses		



## Advanced Accounting

<i>Particulars</i>	<i>Figures as at the end of</i>	
	<i>Current</i>	<i>Previous</i>
	<i>year</i>	<i>year</i>
Selling expenses		
Salaries, wages and other employee benefits		
Managerial remuneration		
Interest		
Depreciation		
Auditor's remuneration		
Provisions for (i) doubtful debts; and (ii) other contingencies (to be specified)		
Any other expenses (See Note 5)		
Total		
III. Profit/loss before tax (I-II)		
IV. Provision for taxation		
V. Profit/loss after tax		
VI. Proposed dividend :		
Preference shares		
Equity shares		
VII. Transfer to reserves/surplus		

### Note to the abridged balance-sheet and the abridged profit and loss account.

1. The amounts to be shown here should be the same as shown in the corresponding aggregated heads in the accounts as per Schedule VI or as near thereto as possible.
2. The total amount of contingent liabilities and that of capital commitments should be shown separately.
3. All notes forming part of the accounts as per Schedule VI to which specific attention has been drawn by the auditors or which form a subject-matter of a qualification by the auditor should be reproduced.



## Company Accounts

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4. If fixed assets are revalued, the amount of revaluation should be shown separately for the first five years subsequent to the date of revaluation.
5. Any item which constitutes 20% or more the total income or expenditure (including Provisions) should be shown separately.
6. Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting, should be disclosed separately.
7. If no provision is made for depreciation, the fact that no provision has been made shall be stated along with the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act.
8. Market value of quoted investments (both of current year and also of previous year) should be mentioned.
9. Any note forming part of the accounts as per Schedule VI which is in the nature of any explanation regarding compliance with any law should be reproduced.
10. Important ratio performance such as sales/total assets ratio, operating profit/capital employed ratio, return on net worth, profit/sales ratio.
11. Details of installed capacity and productivity of main items should be disclosed.
12. Notes in abridged balance sheet should be given the same number as in the main balance sheet.

The above stated salient features of balance-sheet and profit and loss account should be authenticated in the same manner as the main accounts are to be authenticated.

AUDITOR'S REPORT AND COMMENTS IF ANY OF THE COMPTROLLER AND AUDITOR GENERAL OF INDIA UNDER SUB-SECTION (4) OF SECTION 619, IN RESPECT OF GOVERNMENT COMPANIES, AND COMPANIES UNDER SECTION 619B.

—Should be given in full

DIRECTORS'S REPORT

Should be given in full except the information under clause (e) of Sub-section (1) and Sub-section (2A) of Section 217.

(Signed by directors/secretary)

in the manner prescribed in section 215(1)

Recently the aforesaid form has been amended vide No. 3/12/89 - CL V dated 11-5-92 issued by the Ministry of Justice and Company Affairs, Department of Company Affairs. These amendments





## Advanced Accounting

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have been incorporated in the form itself. This amended form stands applicable for the Companies which have closed their accounts on or after 11-5-92.

### Illustration 1

You are required to prepare vertical and horizontal financial statements from the following trial balance of Haria Chemicals Ltd. for the year ended 31st March, 2006.

<b>Haria Chemicals Ltd.</b>			
<b>Trial Balance as at 31st March, 2006</b>			
<i>Particulars</i>	<i>Rs.</i>	<i>Particulars</i>	<i>Rs.</i>
Stock	6,80,000	Equity Shares	
Furniture	2,00,000	Capital (Shares of Rs. 10 each)	25,00,000
Discount	40,000	11% Debentures	5,00,000
Loan to Directors	80,000	Bank loans	6,45,000
Advertisement	20,000	Bills payable	1,25,000
Bad debts	35,000	Creditors	1,56,000
Commission	1,20,000	Sales	42,68,000
Purchases	23,19,000	Rent received	46,000
Plant and Machinery	8,60,000	Transfer fees	10,000
Rentals	25,000	Profit & Loss	
Current account	45,000	account	1,39,000
Cash	8,000	Depreciation	
Interest on bank loans	1,16,000	provision :	
Preliminary expenses	10,000	Machinery	1,46,000
Fixtures	3,00,000		
Wages	9,00,000		
Consumables	84,000		
Freehold land	15,46,000		
Tools & Equipments	2,45,000		



## Company Accounts

Goodwill	2,65,000	
Debtors	2,87,000	
Bills receivable	1,53,000	
Dealer aids	21,000	
Transit insurance	30,000	
Trade expenses	72,000	
Distribution freight	54,000	
Debenture interest	<u>20,000</u>	
	<u>85,35,000</u>	<u>85,35,000</u>

Additional information : Closing stock on 31-3-2006: Rs. 8,23,000.

### Solution

#### Horizontal Financial Statements

##### Haria Chemicals Ltd.

#### Profit and Loss Account for the year ended 31st March, 2006

<i>Particulars</i>	<i>Rs.</i>	<i>Particulars</i>	<i>Rs.</i>
To stock	6,80,000	By sales	42,68,000
To purchases	23,19,000	By rent received	46,000
To consumables	84,000	By transfer fees	10,000
To wages	9,00,000	By stock	8,23,000
To bad debts	35,000		
To discount	40,000		
To rentals	25,000		
To commission	1,20,000		
To interest on bank loans	1,16,000		
To advertisement	20,000		
To dealers' aids	21,000		
To transit insurance	30,000		



## Advanced Accounting

To trade expenses	72,000	
To distribution freight	54,000	
To debenture interest	20,000	
To Net profit	<u>6,11,000</u>	
	<u>51,47,000</u>	<u>51,47,000</u>

### Haria Chemicals Ltd.

#### Balance Sheet as at 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Equity Share Capital	25,00,000	Fixed Assets :	
Reserves & Surplus		Goodwill	2,65,000
Profit & Loss Account	7,50,000	Freehold land	15,46,000
Secured Loans :		Furniture	2,00,000
11% Debentures	5,00,000	Fixtures	3,00,000
Bank loans	6,45,000	Plant & Machinery	
Unsecured Loans :		Less: Depreciation	7,14,000
Current liabilities &		Tools & Equipment	2,45,000
Provisions :		Current Assets,	
Bills payable	1,25,000	Loans & Advances :	
Creditors	1,56,000	(a) Current assets :	
		Stock	8,23,000
		Debtors	2,87,000
		Current account	45,000
		Cash	8,000
		(b) Loans & Advances :	
		Loan to directors	80,000
		Bills receivable	1,53,000
		Miscellaneous expenses :	



## Company Accounts

_____	Preliminary expenses	<u>10,000</u>
<u>46,76,000</u>		<u>46,76,000</u>

### Vertical Financial Statements

Haria chemicals Ltd.

Balance Sheet as at 31st March, 2006

	<i>Schedule No.</i>	<i>Figures as at the end of 31st March 2006</i>
(1)	(2)	(3)
<b>I. Source of Funds</b>		
(1) Shareholders' funds :		
(a) Capital	1	25,00,000
(b) Reserves and Surplus	2	7,50,000
(2) Loan funds :		
(a) Secured loans	3	11,45,000
(b) Unsecured loans		
Total		<u>43,95,000</u>
<b>II. Application of Funds</b>		
(1) Fixed Assets :		
(a) Gross block		34,16,000
(b) Less: Depreciation		<u>1,46,000</u>
(c) Net Block	4	32,70,000
(2) Investments		
(3) Current assets, loans and advances		
(a) Inventories		8,23,000
(b) Debtors		2,87,000
(c) Cash and bank balances	5	53,000



## Advanced Accounting

(d) Loans and advances	6	2,33,000	
(e) Other assets		10,000	
Less :			
Current liabilities and provisions			
(a) Current liabilities	7	2,81,000	
(b) Provisions			
Net current assets			11,25,000
Total			<u>43,95,000</u>

**Note:** Other assets represent preliminary expenses not written off Rs. 10,000.

### Haria Chemicals Ltd.

#### Profit and Loss Account for the year ended 31st March, 2006

	<i>Schedule No.</i>	<i>Figures as at the end of 31st March 2006</i>	
<b>INCOME</b>			
Sales		42,68,000	
Other income	8	<u>56,000</u>	
			43,24,000
<b>Expenditure</b>			
Purchases	9	21,76,000	
Manufacturing & other expenses	10	14,01,000	
Interest & other financial charges	11	1,36,000	
			<u>37,13,000</u>
Profit before tax			6,11,000
Provision for tax			<u>—</u>
Profit after tax			6,11,000
Balance of profit and loss			



## Company Accounts

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account brought forward	<u>1,39,000</u>
Balance carried to balance sheet	<u>7,50,000</u>

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### SCHEDULE 1

Share capital	<i>Rs.</i>
Authorised :	
Equity share capital of Rs. 10 each	<u>25,00,000</u>
Issued and Subscribed :	
Equity share capital of Rs. 10 each	25,00,000

### SCHEDULE 2

Reserves and Surplus	
Balance as per last balance sheet	1,39,000
Balance in profit and loss account	<u>6,11,000</u>
	<u>7,50,000</u>

### SCHEDULE 3

Secured Loans	
11% Debentures	5,00,000
Bank loans	<u>6,45,000</u>
	<u>11,45,000</u>

### SCHEDULE 4

Fixed Assets			
	Gross block	Depreciation	Net Block
Goodwill	2,65,000		2,65,000
Freehold land	15,46,000		15,46,000
Furniture	2,00,000		2,00,000
Fixtures	3,00,000		3,00,000
Plant & Machinery	8,60,000	1,46,000	7,14,000



## Advanced Accounting

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Tools & Equipment	<u>2,45,000</u>		<u>2,45,000</u>
Total	<u>34,16,000</u>	<u>1,46,000</u>	<u>32,70,000</u>

### SCHEDULE 5

Cash and Bank Balances			45,000
Current account balance			<u>8,000</u>
Cash			<u>53,000</u>

### SCHEDULE 6

Loans and Advances			
Loan to directors			80,000
Bills receivable			<u>1,53,000</u>
			<u>2,33,000</u>

### SCHEDULE 7

Current Liabilities			Rs.
Creditors			1,56,000
Bills payable			<u>1,25,000</u>
			<u>2,81,000</u>

### SCHEDULE 8

Other Income			
Rent received			46,000
Transfer fees			<u>10,000</u>
			<u>56,000</u>

### SCHEDULE 9

Purchases			
Opening stock			6,80,000
Add: purchases			23,19,000
Less: Closing stock			<u>8,23,000</u>
			<u>21,76,000</u>



SCHEDULE 10

Manufacturing and Other Expenses	
Consumables	84,000
Wages	9,00,000
Bad debts	35,000
Discount	40,000
Rentals	25,000
Commission	1,20,000
Advertisement	20,000
Dealers' aids	21,000
Transit insurance	30,000
Trade expenses	72,000
Distribution freight	<u>54,000</u>
	<u>14,01,000</u>

SCHEDULE 11

Interest and Other Financial Charges	
Interest on bank loans	1,16,000
Debenture interest	<u>20,000</u>
	<u>1,36,000</u>

**1.7 MANAGERIAL REMUNERATION**

Managerial remuneration is calculated as a percentage on profit. Managerial remuneration payable by a company is governed by various sections of the Companies Act, 1956 and also Schedule XIII of the Companies Act, 1956. The scope of the relevant sections are as below :

*Section 198* prescribes the overall maximum managerial remuneration payable and also managerial remuneration in case of absence or inadequacy of profits.

*Section 309* prescribes the remuneration payable to whole-time directors and part-time directors.

*Section 310* states that if there is an increase in managerial remuneration within the scope of Schedule XIII and within the overall ceiling, permission of Central Government is not required for such increase. In other words sanction of Central Government will be required only if the increase in managerial remuneration has the effect of exceeding the overall ceiling as given in Section 198.





## Advanced Accounting

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*Section 349* lays down how the net profit of the company will be ascertained for the purpose of calculating managerial remuneration.

*Section 387* deals with remuneration of manager. Remuneration to manager cannot exceed in the aggregate five per cent of the net profits. However, a manager is included within the scope of the term 'managerial person'.

*Schedule XIII* consists of three parts. Part I lays down conditions to be fulfilled for the appointment of a managing or wholetime director or a manager without the approval of the Central Government. Part II deals with remuneration payable to managerial person by companies having profits and also by companies having no profits or inadequate profits. Part III specifies the provisions applicable to earlier parts of the schedule.

It may be noted that the Central Government had amended Schedule XIII to the Companies Act, 1956 on 14th July, 1993 introducing sweeping changes in provisions governing managerial appointment and remuneration. As a result of such amendment, the ceiling on commission on net profit was withdrawn. With a view to give still greater freedom to companies in regard to managerial appointment and remuneration, Central Government have once again amended Schedule XIII to the Companies Act, 1956 effective from 1st February, 1994.

Managerial Remuneration : Maximum limits :

(A) For companies having profits:

(i)	Overall (excluding fees for attending meetings)	11% of net profit
(ii)	If there is one managerial person	5% of net profit
(iii)	If there are more than one managerial person	10% of net profit
(iv)	Remuneration of part-time directors :	
(a)	If there is no managing or whole-time director	3% of net profit
(b)	If there is a managing or whole-time director	1% of net profit

(B) For companies having no profits or inadequate profits :

In the event of absence or inadequacy of net profits in any financial year, managerial remuneration will have to be limited to amounts (varying from Rs. 40,000 per month to Rs. 87,500 per month, depending on the effective capital of the company) specified in Section II of Part II of Schedule XIII. Such remuneration may be paid as 'minimum remuneration' without the approval of the Central Government. However, approval of the Central Government will be required if such 'minimum remuneration' is sought to be exceeded. Loss making companies or companies with inadequate net profits have the freedom to work out suitable remuneration packages for their managerial personnel within the limits specified in Section II of Part II of Schedule XIII.



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The remuneration of managerial person in case of absence or inadequacy of profits shall be calculated on the following scale [vide circular CL-V dated 2nd March, 2000, issued by Department of Company Affairs]

<i>Where the effective capital of company is :</i>	<i>Monthly remuneration payable shall not exceed :</i>
(i) Less than Rs. 1 crore	Rs. 75,000
(ii) Rs. 1 crore or more but less than Rs. 5 crores	Rs. 1,00,000
(iii) Rs. 5 crores or more but less than Rs. 25 crores	Rs. 1,25,000
(ix) Rs. 25 crores or more but less than Rs.100 crores	Rs. 2,00,000

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

### *Explanation :*

1. Managerial persons include managing or whole-time director and manager.
2. Effective capital means the aggregate of the paid-up share capital (excluding share application money or advances against shares), amount, if any, for the time being standing to the credit of share premium account, reserves and surplus (excluding revaluation reserves), long-term loans and deposits repayable after one year (excluding working capital loans, over-drafts, interest due on loans unless funded, bank guarantee etc. and other short-term arrangements) as reduced by the aggregate of any investments (except in the case of investment by an investment company), accumulated losses and preliminary expenses not written off.

### **Ascertainment of profit for managerial remuneration**

As we have seen above that in case of a company having profits, managerial remuneration is calculated as a percentage on net profit. Such net profit is to be arrived in accordance with the provisions of Section 349 of the Companies Act, 1956.

The following credits or incomes in addition to the gross profit should be taken into account:

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

The following "incomes" or credits should not be taken into account :



## Advanced Accounting

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- (a) premium on shares or debentures issued or sold by the company;
- (b) profit on sale by the company of forfeited shares;
- (c) profits of a capital nature including profit from the sale of the undertaking or any of the undertakings of the company, or any part thereof; and
- (d) profits from the sale of any immovable property of fixed assets of capital nature comprised in the undertaking or any of the undertakings of the company, unless the business of the company consists, whether wholly or partly, of buying and selling such property or assets.

But where the amount for which any fixed asset is sold exceeds its written down value (calculated according to Section 350) credit should be given for such of the excess as is not higher than the difference between the original cost of that fixed asset and its written down value: Suppose a machine purchased for Rs. 30,000, written down to Rs. 18,000 by writing off depreciation, is sold for Rs. 35,000. The managerial personnel are entitled to remuneration on profit including Rs. 12,000 *i.e.*, excluding the profit over and above the original cost of Rs. 5,000.

From the incomes of the company, the following have to be deducted :

- (a) all the usual working charges;
- (b) bonus or commission paid or payable to any member of the company's staff or any engineer, technician or person employed or engaged by the company whether on a wholetime or on a part-time basis;
- (c) any tax notified by the Central Government as being in the nature of a tax on excess or abnormal profit;
- (d) any tax on business profit imposed for special reasons or in special circumstances notified by the Central Government in this behalf;
- (e) interest on debentures issued by the company;
- (f) interest on mortgages executed by the company and on loans and advances secured by a charge on its fixed or floating assets.
- (g) interest on unsecured loans and advances;
- (h) expenses on repairs, whether to immovable property or to movable property, provided the repairs are not of a capital nature;
- (i) outgoings, inclusive of contributions made under clause (of sub-section) of Section 293. This relates to donations to charitable funds;
- (j) depreciation calculated according to Section 350. Under Section 350 the depreciation (for the purpose of calculating remuneration to managerial personnel) is to be calculated according to the rates specified in Schedule XIV. Depreciation includes only normal depreciation including extra



and multiple shift allowance but excluding any special, initial or other depreciation or any development rebate.

If an asset is sold, discarded, demolished or destroyed before it is completely written off, the excess of the written down value over its sale proceeds or its scrap value has to be written off in the financial year in which the assets is sold, discarded, demolished or destroyed;

(k) the excess of expenditure over income which arises in computing the net profit in accordance with this section in any year (after the commencement of the Act) in so far as its excess has not been deducted in any subsequent year preceding the year in respect of which the net profit have to be ascertained;

(l) any compensation or damage to be paid in by virtue of any legal liability including a liability arising from a breach of contract;

(m) any sum paid by way of insurance against the risk of meeting any liability such as is referred to in (m); and

(n) debts considered bad and written off or adjusted during the year of account.

Profit on which remuneration has to be allowed should be ascertained without deducting the following :

(a) income-tax and super tax payable by the company under the Income-tax Act or any other tax on the income of the company not covered by (d) and (e) above;

(b) any compensation, damages or payment made voluntarily, that is to say, otherwise than by virtue of a liability such as is referred to in (m) above; and

(c) loss of a capital nature including loss or sale of the undertaking or any of the undertakings of the company or of any part thereof not including in any excess of written down value over its sale proceeds of scrap value of any asset sold. The excess has to be written off to the Profit and Loss A/c.

It should be noted that the Profit and Loss Account should have a statement attached showing how profit has been ascertained for the purpose of remuneration due to directors, managing director or manager as per the requirements of paras 4 and 4A of Part II, Schedule VI.



## Advanced Accounting

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### Illustration 2

The following is the Profit & Loss A/c of Mudra Ltd., the year ended 31st March, 2006

	<i>Rs.</i>		<i>Rs.</i>
To Administrative, Selling and distribution expenses	8,22,542	By Balance b/d	5,72,350
" Donation to charitable funds	25,500	"Balance from Trading A/c	40,25,365
" Directors fees	66,750	"Subsidies received from Govt.	2,32,560
" Interest on debentures	31,240	"Interest on Investments	15,643
" Compensation for breach of contract	42,530	"Transfer fees	722
" Managerial remuneration	2,85,350	"Profit on sale of Machinery:	
" Depreciation on fixed assets	5,22,543	Amount realised	55,000
" Provision for Taxation	12,42,500	Written down value	<u>30,000</u> 25,000
" General Reserve	4,00,000		
" Investment Revaluation Reserve	12,500		
" Balance c/d	<u>14,20,185</u>		
	<u>48,71,640</u>		<u>48,71,640</u>

#### Additional Information:

- (1) Original Cost of the machinery sold was Rs. 40,000
- (2) Depreciation on fixed assets as per Schedule XIV of the Companies Act, 1956 was Rs.5,75,345.

You are required to comment on the managerial remuneration in the following situations:

- (a) there is only one whole time director;
- (b) there are two whole time directors;
- (c) there are two whole time directors, a part time director and a manager.



**Solution :**

**Calculation of net profit u/s 349 of the Companies Act, 1956**

	Rs.	Rs.
Balance from Trading A/c		40,25,365
<i>Add:</i> Subsidies received from Government		2,32,560
Interest on investment		15,643
Transfer fees		722
Profit on sale of machinery (40,000 – 30,000)	<u>10,000</u>	2,58,925
		42,84,290
<i>Less:</i> Administrative, selling and distribution expenses		8,22,542
Donation to charitable funds	25,500	
Director's fees	66,750	
Interest on debentures	31,240	
Compensation for breach of contract	42,530	
Depreciation on fixed assets as per Schedule XIV	<u>5,75,345</u>	<u>15,63,907</u>
Profit u/s 349		<u>27,20,383</u>

**Situation:**

(a) When there is only one whole time director:

Managerial remuneration = 5% of Rs. 27,20,383 = Rs. 1,36,019

(b) When there are two whole time directors :

Managerial remuneration = 10% of Rs. 27,20,383 = Rs. 2,72,038

(c) When there are two whole time directors, a part time director and a manager:

Managerial remuneration = 11% of Rs. 27,20,383 = Rs. 2,99,242

*Comment :* In situations (a) and (b) since managerial remuneration as per Profit and Loss account Rs. 2,85,350 exceeds the maximum amount payable, the company should obtain permission under Section 309(3) for such excess payment.



**Illustration 3**

The following extract of Balance sheet of X Ltd. was obtained:

**Balance sheet (Extract) as on 31st march, 2006**

<i>Liabilities</i>	<i>Rs.</i>
Authorised capital:	
20,000, 14% preference shares of Rs. 100	20,00,000
2,00,000 Equity shares of Rs. 100 each	<u>2,00,00,000</u>
	<u>2,20,00,000</u>
Issued and subscribed capital:	
15,000, 14% preference shares of Rs. 100 each fully paid	15,00,000
1,20,000 Equity shares of Rs. 100 each, Rs. 80 paid-up	96,00,000
Share suspense account	20,00,000
Reserves and surplus	
Capital reserves (60% is revaluation reserve)	2,50,000
Securities premium	50,000
Secured loans:	
15% Debentures	65,00,000
Unsecured loans:	
Public deposits	3,70,000
Cash credit loan from SBI	4,65,000
Current Liabilities:	
Sundry creditors	<u>3,45,000</u>
Assets:	
Investment in shares, debentures, etc.	75,00,000
Profit and Loss account	15,25,000
Preliminary expenses not written off	<u>55,000</u>

Share suspense account represents application money received on shares the allotment of which is not yet made.



## Company Accounts

X Ltd. has been sustaining loss for the last few years. X Ltd. has only one whole-time director. Find out how much remuneration X Ltd. can pay to its managerial person as per the provisions of Part II of Schedule XIII. Would your answer differ if X Ltd. is an investment company?

### Solution :

Computation of effective capital :

	<i>Where X Ltd. is a non-invest- ment company</i>	<i>Where X Ltd. is an invest- ment company</i>
	<i>Rs.</i>	<i>Rs.</i>
Paid-up share capital —		
15,000, 14% Preference shares	15,00,000	15,00,000
1,20,000 Equity shares	96,00,000	96,00,000
Capital reserves	1,00,000	1,00,000
Securities premium	50,000	50,000
15% Debentures	65,00,000	65,00,000
Public Deposits	<u>3,70,000</u>	<u>3,70,000</u>
(A)	<u>1,81,20,000</u>	<u>1,81,20,000</u>
Investments	75,00,000	—
Profit and Loss account (Dr. balance)	15,25,000	15,25,000
Preliminary expenses not written off	<u>55,000</u>	<u>55,000</u>
(B)	<u>90,80,000</u>	<u>15,80,000</u>
Effective capital (A–B)	<u>90,40,000</u>	<u>1,65,40,000</u>
Monthly remuneration shall not exceed	<u>75,000</u>	<u>1,00,000</u>

### 1.8 DIVISIBLE PROFIT

One of the important functions of company accounting is to determine the amount of profits which is available for distribution. This is necessary since the amount of profits disclosed by the Profit & Loss Account, in every case, is not available for distribution.





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The availability of profits for distribution depends on a number of factors, *e.g.*, their composition, the amount of provisions and appropriations that must be made out of them in priority, etc.

*Dividends cannot be declared except out of profits* - Declaration of a dividend presupposes that there is a trading profit or a surplus available for distribution, arrived at after providing for depreciation on assets, not only for the year in which the profits were earned but also for any arrears of depreciation of the past years, calculated in the manner prescribed by sub-section (2) of Section 205 (*see below*). The balance of undistributed profits of the past years, provided the same has been arrived at in a like manner, is also available for distribution. Any money provided by the Central or State Government for any payment of dividend in pursuance of a guarantee given by the Government also is available for distribution as a dividend.

*Capital cannot be returned to the shareholders by way of dividend* — Under the Companies Act it is not obligatory for a company to maintain its capital intact. But the Act has prescribed the procedure for reduction of capital. It must be followed in every case if the paid-up capital is to be reduced. Therefore, no part of the capital can be paid unless there is profit. But interest may be paid under Section 208.

*Provision for Depreciation* — Section 205(2) provides that depreciation must be provided either —

- (a) to the extent specified in Section 350.
- (b) equal to an amount arrived at by dividing 95% of the cost of the asset by the number of years at the end of which the asset would cease to be serviceable; or
- (c) on any other basis approved by the Central Government by which 95% of the cost of each depreciable assets will be written off on the expiry of its serviceable life; or
- (d) As regards any other depreciable asset for which no rate of depreciation has been laid down by the Companies Act, 1956 or any rules made thereunder, on such basis as may be approved by the Central Government by any general order published in the Official Gazette or by any special order in any particular case.

Section 350 provides that depreciation should be written off at the rates specified for different assets in Schedule XIV to the Companies Act, 1956. Provision is required only for the normal depreciation (including extra and multiple shift allowance) and not for any initial depreciation or any development rebate. Further, when the assets are sold, discarded, demolished or destroyed in any financial year, the excess of the written down value over its sale proceeds as scrap, if any should be written off in the same financial year.

Section 350 contemplates that depreciation on assets shall be computed with reference to the written down value of the assets as shown by the books of the company at the end of the financial year. The Amendment Act, 2000 has replaced the words "the amount calculated with reference to the written down value of the assets" with "the amount of depreciation on assets". Thus any other



method of depreciation is also allowed. Earlier only written down value of method could be used for the purpose of calculation of depreciation under this section.

It should be noted that depreciation has to be written off or provided for if dividends are to be declared; a company need not provide for depreciation if it does not want to declare dividends. In such a case, the fact that depreciation has not been provided for or written off, together with the quantum of arrears of depreciation [computed as per Section 205(2)], must be stated in the Profit and Loss Account.

If provision for depreciation is not made by means of a depreciation charge but by some other method, the method adopted should be disclosed.

**N.B.** For purpose of ascertaining profit on which remuneration is to be paid to managerial personnel, depreciation according to Section 350 is to be considered.

*Loss suffered in the past may not be made good* - Where a company has incurred any loss in any previous financial year or years, Sub-section (2) of Section 205 prescribes that it must set off either the loss or an amount which is equal to the amount provided for as depreciation in that year or those years whichever is less, against the profit of the company for the year, out of which the dividend is proposed to be declared or paid. Thus, the losses suffered in the past or at least amount of depreciation on assets comprised therein, must first be made good out of the profits of a year before any part thereof is distributed as a dividend. This is illustrated below :

		<i>Year ended 31st December</i>			
		<i>(in Rs. lakhs)</i>			
		2003	2004	2005	
Total					
1.	Depreciation as provided in the books	3	2	8	13
2.	Depreciation chargeable under section 205	13	10	8	31
3.	Profit before charging depreciation	-15	-7	37	15
4.	Profit after charging depreciation as in (1)	-18	-9	29	2
5.	Profit after charging depreciation as in (2)	-28	-17	29	-16

The amount available for dividend in 2005 is Rs. 6,00,000 as shown below :

A.	Past Losses [4]			27
B.	Depreciation previously provided [1]			5
C.	Depreciation in arrear [2-1]			

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	2004	8	
	2005	<u>Nil</u>	<u>18</u>
Profit for 2005 (as per books)			29
Less: Arrears of Depreciation not provided for as per (C) above, which must be now provided			<u>18</u>
			11
Less: Amount of depreciation provided (B) or the loss (A), whichever is less			<u>5</u>
Distributable Profit			<u>6</u>
This amount of Rs. 6,00,000 may also be arrived at as follows :			
Profit for 2005 (before charging depreciation)			37
Less: Total depreciation for 3 years u/s 205			<u>31</u>
Distributable Profit			<u>6</u>

However, one should note that before the amendment of the Companies Act in 1960 the legal position was according to the decisions in various cases in England. Therefore, it was not necessary to provide for depreciation on fixed assets or past losses for declaring a dividend (*Ammonia Soda Co. v. Chamberlain and Stapley v. Read Bros Ltd.*). It is still not necessary to provide arrears of depreciation and losses relating to the financial year falling before 28th December 1961.

*Distribution of Capital Profit* - Any capital profit or any appreciation in the value of fixed asset in the case of a company may be distributed as dividend provided (i) the revaluation of all the assets discloses a surplus; (ii) the profit has been realised in cash; (iii) and the article of the company permit such a distribution, (*Lubbok v. British Bank of South America and Foster v. The New Trinidad Lake Asphalte Co. Ltd.*).

*Writing off losses against capital profits* - It is permissible for a company to revalue its assets but the revaluation must be in a *bona fide* manner. Depending upon the results disclosed by such a revaluation, with the approval of the shareholders, the assets, which may have been over depreciated in the past may be written up and the surplus, if any, resulting therefrom utilised for writing down value of other assets, so that the value of each asset is brought closer to its current value (*Ammonia Soda Co. v. Chamberlain*).

Where any expenditure of a capital nature has been charged to revenue the company can subsequently reimburse an equal amount of revenue, out of capital. Similarly, when losses on



capital account have been charged off to revenue and later the value of the capital assets appreciates, the amount so realised would be a revenue profit (*Mills v. Northern Railway of Buenos Aires Co.*).

**Transfer to Reserves :** The Board of Directors, unless prohibited by the Articles, can appropriate a part of the profits to the credit of a reserve or reserves. Appropriation of a part of profit is sometimes made under law. For example, under the Banking Regulation Act, 20% of the profit of a banking company must first be transferred to the General Reserve before any dividend can be distributed. Similarly, when profit of a licence under the Electricity Supply Act, 1984 exceeds the amount of reasonable return, a part (about 1/3 of the excess) has to be transferred to the Tariffs and Dividend Control Reserve. Transfer of a part of profit to a reserve is also necessary where the company has undertaken, at the time of raising of loan, that before any part of its profit is distributed, a specified percentage of the profit every year shall be credited to a reserve for the repayment of the loan and until the time for repayment arrives, the amount shall remain invested in a specified manner. Apart from appropriations aforementioned, it may also be necessary to provide for losses and arrears of depreciation and to exclude capital profit, as mentioned earlier, to arrive at the amount of divisible profit.

The changes made in the company law (effective 1st February, 1975) now authorises Government to compel companies to transfer a part of their after tax profits to reserve. The Government has promulgated the following rules in this regard:

(1) No dividend shall be declared or paid by the company for any financial year out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Sub-section (2) of Section 205 of the Act, except after the transfer to the reserve of the company of a percentage of its profit for that year as specified below :

(i) Where the proposed dividend exceeds 10 per cent but does not exceed 12.5 per cent of the paid-up capital, the amount not be transferred to the reserve shall not be less than 2.5 per cent of the current profits;

(ii) Where the proposed dividend exceeds 12.5 per cent but does not exceed 15 per cent of the paid up capital, the amount to be transferred to the reserve shall not be less than 5 per cent of the current profits;

(iii) Where the proposed dividend exceeds 15 per cent, but does not exceed 20 per cent of the paid up capital, the amount to be transferred to the reserves shall not be less than 7.5 per cent of the current profit; and

(iv) Where the dividend proposed exceeds 20 per cent of the paid-up capital the amount to be transferred to reserve shall not be less than 10 per cent of the current profits.



(2) Nothing in rule (1) shall be deemed to prohibit the voluntary transfer by a company of a percentage higher than 10 per cent of its profit to its reserves for any financial year, so however that :

(i) Where a dividend is declared:

(a) a minimum distribution sufficient for the maintenance of dividends to shareholders at a rate equal to the average of the rates at which dividends declared by it over the three years immediately preceding the financial year; or

(b) in a case where bonus shares have been issued in the financial year in which the dividend is declared or in the three years immediately preceding the financial year, a minimum distribution sufficient for the maintenance of dividend to shareholders at an amount equal to the average amount (quantum) of dividend declared over the three years immediately preceding the financial year is ensured; Provided that in a case where the net profits after tax are lower by 20% or more than the average net profit after tax of the two financial years immediately preceding, it shall not be necessary to ensure such minimum distribution.

(ii) Where no dividend is declared, the amount proposed to be transferred to its reserves from the current profit shall be lower than the average amount of the dividends to the shareholders declared by it over the three years immediately preceding the financial year.

**Declaration of dividend out of reserves** : Government have promulgated rules regarding utilisation of reserves for payment of dividend. In the event of inadequacy or absence of profit in any year, dividend may be declared by a company for that year out of the accumulated profit earned by it in previous years and transferred by it to the reserves, subject to the condition that:

(i) the rate of the dividend declared shall not exceed the average of the rates at which dividend was declared by it in five years immediately preceding that year or ten per cent of its paid-up capital, whichever is less;

(ii) the total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves shall not exceed an amount equal to one-tenth of the sum of its paid up capital and free reserves and the amount so drawn shall first be utilised to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared; and

(iii) the balance of reserves after such drawal shall not fall below fifteen per cent of its paid up share capital.

*Interest on Capital* : As has been pointed out above, dividends cannot be paid except out of profits or, in other words, dividends cannot be paid out of capital. In certain cases, however, the Central Government has the power to permit payment of interest to shareholders even when there is no profit. A company which has to wait rather a long period before it can commence production because construction of works may take long may find the shareholders restive if nothing is given



to them by way of yield. Moreover, if construction is carried on by borrowed funds interest will have to be paid; hence there is some theoretical justification for payment of interest to the shareholders. Section 208 governs payment of interest in such cases. The company is allowed to pay interest on such shares as are issued for the purpose of defraying the expenses of the construction of any works of building or providing any plant which cannot be made profitable for a lengthy period, subject to the following conditions:

- (a) The payment is authorised by Articles or by a special resolution.
- (b) Prior sanction of the Central Government is obtained.
- (c) Interest is paid only for such period as may be determined by the Central Government.

But the period cannot extend beyond the close of the half year next after the half year in which the works, buildings, etc., have been actually completed. For example, if the construction is over on 10th October, 2005, interest cannot be paid after 30th June 2006.

- (d) The rate of interest does not exceed four per cent *per annum* or such other rates as the Central Government may, by notification in the Official Gazette, direct.

The Central Government can order an enquiry at the company's cost before according its sanction, the company can treat the interest so paid as part of the cost of construction.

**Profit and Loss (Appropriation) Account:** The provisions contained in Part II of Schedule VI of the Companies Act require that the undermentioned appropriations made out of profit should be disclosed in the Profit and Loss Account of the year:

- (a) Amounts provided for:
  - (i) repayment of share capital; and
  - (ii) repayment of loans [clause (vi)].
  
- (b) (i) The aggregate, if material, of any amount set aside or proposed to be set aside to reserves, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as at which the balance sheet is made up.
  - (ii) The aggregate, if material, of the amounts withdrawn from such reserves [clause (viii)].
  
- (c) (i) The aggregate, if material, of the amount set aside to provisions made for meeting specific liabilities, contingencies or commitments.



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(ii) The aggregate, if material, of the amounts withdrawn from such provisions as no longer required [clause (ix)].

(d) the aggregate amount of dividend paid and proposed and stating whether such amounts are subjects to deduction of income-tax or not [clause (XIV)]

It is evident therefore that it is necessary to disclose in the Profit & Loss Account amount withdrawn from reserves, excess provisions written back and appropriation proposed by the directors out of profits.

One should note that provisions for income-tax relating to the current year is no longer treated as an appropriation of profits - at one time it was.

With a view to distinguish the appropriation of profits from expenses chargeable against profits, the Research Department of the Institute has made the following recommendations:

"The Profit & Loss Account should be prepared in two parts:

(i) The Profit and Loss Account, proper, include all income and expenditure properly attributable to the year's working and show the figure of profit or loss for the year; and

(ii) The second part of the account should include all appropriations for dividends, transfers to and from reserves."

When appropriations are shown in a separate section in the Profit & Loss account, an imaginary line is supposed to separate them from income and expenses of the year. The account, therefore, refers to amount being shown above or below the 'line' depending on whether the amount is chargeable in the Profit and Loss section or the Appropriation section.

It is pertinent to mention here that clause (3) of Part II of Schedule VI states that the Profit & Loss account shall set out items relating to income and expenditure of the company, arranged under the most convenient heads in respect of the period covered by the account. It would, therefore appear that when an addition to or a deduction from a reserve has no impact on the profit and loss of the period of account, such an addition or deduction need not be passed through the Profit & Loss Account.

**Capital reserve** : It is the reserve which does not include any amount regarded as free for distribution through the Profit and Loss account. Share Premium and Capital Redemption Reserve Account should not be credited to capital reserve; these accounts have to be kept separate. Only profits or a surplus of a capital nature can be credited to such a reserve. The following are instances of profit or surpluses which can be so created:

1. Profit prior to incorporation.
2. Capital profit on sale of fixed assets when these are not available for distribution as dividends in the circumstances mentioned below :



- (i) where the profit on sale of a fixed asset has not been realised; or
  - (ii) where the profit on sale of fixed assets though realised is likely to be wiped out by the deficiency on revaluation of other assets; or
  - (iii) where the Articles of Association do not permit distribution of such profit as a dividend.
3. The excess of the value of net assets over the price paid for the acquisition of a business.
  4. Profit on re-issue of forfeited shares. (Premiums received on issue of shares according to the provisions contained under Section 78 are to be credited to Shares Premium Account.)
  5. The credit balance in the Capital Reduction Account, where there has been a reduction of capital with the consent of the Court.
  6. Premiums received on issue of debentures or profits on redemption of debentures where the distribution of such profits is not permitted by the Articles.

**Dividends** : A dividend is a distribution of divisible profit of a company among the members according to the number of shares held by each of them in the capital of the company and the rights attaching thereto. Such a distribution may or may not entail a release of assets; it would be where a distribution involves payment of cash. But when profits are capitalised and the amount distributed is applied towards payment of bonus shares, issued free to the share holders, no part of the assets of the company can be said to have been released since, in such a case, profits are only capitalised, thereby increasing the paid up capital of the company. The company does not give up any asset.

A dividend is declared in the annual general meeting on the basis of the recommendation of the Board of Directors. Though the shareholders may declare a dividend smaller than recommended by the Board, they cannot declare a larger dividend or any dividend when none has been recommended (Clause 85 of Table A of Schedule I of the Companies Act). The Board of Directors may, from time to time, pay to the members an interim dividend at a rate which may appear to be justified by the amounts of profit earned by the company (Clause 86 of table A of Schedule I to the Companies Act). The interim dividend is not adjusted when the final dividend is declared (that is the final dividend is in addition to the interim dividend) unless the resolution declaring the dividend states otherwise.

It is thus apparent that the Board of Directors determines the amount of profit which is to be distributed as a dividend as well as the time at which the distribution shall be made.

*Interim Dividend* : The Companies (Amendment) Act, 2000 has inserted new sub-section (14 A) in Section 2 of the Companies Act which includes 'interim dividend' in the definition of the term 'dividend'.

*Dividend on preference shares* : Holders of preference shares are entitled to receive a dividend at a fixed rate before any dividend is declared on equity shares. But such a right can be exercised





subject to there being profits and the Directors recommending payment of the dividend. In the case of cumulative preference shares the holders are entitled to receive all the dividends which are in arrear before any dividend is paid on equity shares. For instance, suppose a company has not paid a dividend say, for five years and in the sixth year it earns a handsome profit. If Directors decide to declare a dividend on equity shares, it would be necessary to make a provision first for the payment of one year's dividend to holders of preference shares, if they are non-cumulative. If on the other hand, the right is cumulative, a provision for payment of dividends due to the preference shares for all the six years shall first have to be made before any dividend is declared on equity shares.

In respect of preference shares issued before 1st April, 1960, the dividend payable is to be increased by 30% if the dividend payable was stipulated to be tax free and by 11% in the other case [Preference Shares (Regulation & Dividend) Act, 1960].

*Dividend on partly paid shares* : In the case of partly paid-up shares, the dividend is payable either on the nominal, called up or the paid-up amount of shares, depending on the provision in this regard that there may be in the Articles. In the absence of any such provision, Table A would be applicable. In such a case the amount of dividend payable will be calculated on the amount paid up on shares, and while doing so, the dates on which the amounts were paid must be taken into account. Calls paid in advance do not rank for payment of dividend. Instead, interest may be paid on such calls; the rate of interest is 6% p.a. according to Table A; Articles of a company may prescribe a different rate. A company may if so authorised by its Article, pay a dividend in proportion to the amount paid on each share, where a larger amount is paid on some share than on other (Section 93). But where the Articles are silent and Table A has been excluded, the amount of dividend payment will have to be calculated on nominal amount of shares. It should, however, be noted that according to the Clause 88 of Table A, dividends are to be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend, is paid but, if and so long as nothing is paid upon any of the shares in the company, dividends may be declared and paid according to the nominal amounts of the shares.

In the case of fresh issue of capital, the holders thereof, unless precluded by the terms of issue, are entitled to receive dividend *pari passu* with the shares already issued.

*Payment* : All dividends must be paid in cash [Section 205(3)]; dividend warrants, made payable at a bank are treated as cash. Dividend must be paid within 30 days of declaration. The following provisions of law [after the introduction of the Companies (Amendment) Act, 1999 and Companies (Amendment) Act, 2000] should be noted :

(j) Where a dividend has been declared by a company but has not been paid, or claimed, within thirty days from the date of the declaration, to any shareholder entitled to the payment of the dividend, the company shall within seven days from the date of expiry of the said period of thirty days, transfer the total amount of dividend which remains unpaid or unclaimed within the said period of thirty days to a special account to be opened by the company in that behalf in any



sheduled bank to be called "Unpaid Dividend Account of \_ \_ \_ \_ \_ Company Limited/Company (Private) Limited.

(ii) Any money transferred to the unpaid dividend account of a company in pursuance of this section which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the Fund established under Sub-section (7) of Section 205C."

(iii) In Section 205 of the Principal Act after sub-section (1), the following sub-sections have been inserted by the Companies Amendment Act, 2000 namely :

(1A) The Board of Directors may declare interim dividend and the amount of dividend including interim dividend shall be deposited in a separate bank account within five days from the date of declaration of such dividend.

(1B) The amount of dividend including interim dividend so deposited under sub-section (1A) shall be used for payment of interim dividend

(1C) the provisions contained in sections 205, 205A, 205C, 206, 206A and 207 shall, as for as may be, also apply to any interim dividend.

(iv) Section 55A (inserted by Companies Amendment Act, 2000) grants power to Securities and Exchange Board of India in respect of the listed companies for the matters relating to issue and transfer of securities and non-payment of dividend.

(v) Substitution of new section for 207. – For section 207 of the principal Act, the following section shall be substituted, namely :

Penalty for failure to distribute dividends within thirty days. – Where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within thirty days from the date of declaration, to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to three years and shall also be liable to a fine of one thousand rupees for every day during which such default continues and the company shall be liable to pay simple interest at the rate of eighteen per cent per annum during the period for which such default continues :

Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provisions in the following cases, namely :

- (a) where the dividend could not be paid by reason of the operation of any law;
- (b) where a shareholder has give directions to the company regarding the payment of the dividend and those directions cannot be complied with;
- (c) where there is a dispute regarding the right to receive the dividend;



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(d) where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

(e) where, for any other reason, the failure to pay the dividend or to post the warrant within the period aforesaid was not due to any default on the part of the company.

Under Section 205C (7), the Central Government shall establish a fund to be called the Investor Education and Protection Fund (hereafter in this section referred to as the "Fund").

There shall be credited to the Fund the following amounts, namely :

(a) amounts in the paid dividend account of companies;

(b) the application moneys received by companies for allotment of any securities and due for refund;

(c) matured deposits with companies;

(d) matured debentures with companies;

(e) the interest accrued on the amount referred to in clauses (a) to (d);

(f) grants and donations given to the Fund by the Central Government, State Governments, companies or any other institutions for the purpose of the Fund; and

(g) the interest or other income received out of the investments made from the Fund:

Provided that no such amounts referred to in clauses (a) to (d) shall form part of the Fund unless such amounts have remained unclaimed and unpaid for a period of seven years from the date they became due for payment.

*Explanation* : For the removal of doubts, it is hereby declared that no claims shall lie against the Fund or the company in respect of individual amounts which were unclaimed and unpaid for a period of seven years from the dates that they first became due for payment and no payment shall be made in respect of any such claims.

The Fund shall be utilised for promotion of investor awareness and protection of the interests of investors in accordance with such rules as may be prescribed.

**Corporate Dividend Tax:** The Finance Act, 1997, has introduced Chapter XIID (Sections 115O and 115 Q) on "Special Provisions Relating to Tax on Distributed profits of Domestic Companies" [Hereinafter referred to as 'CDT' (Corporate Dividend Tax)]. The ICAI has issued Guidance Note on Accounting for Corporate Dividend Tax.

The salient features of CDT are as below:

(i) CDT is in addition to the income-tax chargeable in respect of the total income of a domestic company.



- (ii) CDT is chargeable on any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) on or after the 1st day of June 1997.
- (iii) The dividends chargeable to CDT may be out of the current profits or accumulated profits.
- (iv) The rate of CDT is ten per cent.
- (v) CDT shall be payable even if no income-tax is payable by the domestic company on its total income.
- (vi) CDT is payable to the credit of the Central Government within 14 days of
  - (a) declaration of any dividend,
  - (b) distribution of any dividend, or
  - (c) payment of any dividend.

whichever is the earliest.

(vii) CDT paid shall be treated as the final payment of tax on the dividends and no further credit therefor shall be claimed by the company or by any person in respect of the tax so paid.

(viii) The expression 'dividend' shall have the same meaning as is given to 'dividend' in clause (22) of Section 2 but shall not include sub-clause(e) thereof.

**Accounting for CDT:** According to generally accepted accounting principles, the provision for dividend is recognised in the financial statements of the year to which the dividend relates. In view of this, CDT on dividend, being directly linked to the amount of the dividend concerned, should also be reflected in the accounts of the same financial year even though the actual tax liability in respect thereof may arise in a different year.

**Disclosure and Presentation of CDT in Financial Statements:** It is noted that clause 3(vi) of Part II of Schedule VI to the Companies Act, 1956, requires the disclosure of "the amount of charge for Indian Income-tax and other Indian taxation on profits, including, where practicable, with Indian income-tax any taxation imposed elsewhere to the extent of the relief, if any, from Indian income-tax and distinguishing, where practicable, between income-tax and other taxation." It is also noted that Part II of Schedule VI only lays down the information to be disclosed in the profit and loss account. However, as a matter of convention and to improve readability, the information in the profit and loss account is generally shown in two parts, viz., the first part contains the information which is required to arrive at the figure of the current year's profit-often referred to as 'above the line', and the second part which discloses, inter alia, information involving the appropriations of the current year's profits - often referred to as 'below the line'.

Since dividends are disclosed 'below the line', a question arises with regard to disclosure and presentation of CDT, as to whether the said tax should also be disclosed 'below the line' or should be disclosed along with the normal income-tax provision for the year 'above the line'.



## Advanced Accounting

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The liability in respect of CDT arises only if the profits are distributed as dividends whereas the normal income-tax liability arises on the earning of the taxable profits. Since the CDT liability relates to distribution of profits as dividends which are disclosed 'below the line', it is appropriate that the liability in respect of CDT should also be disclosed 'below the line' as a separate item. It is felt that such a disclosure would give a proper picture regarding payments involved with reference to dividends.

CDT liability should be recognised in the accounts of the same financial year in which the dividend concerned is recognised.

CDT liability should be disclosed separately in the profit and loss account, 'below the line', as follows:

Dividend		XXXXX
Corporate Dividend Tax thereon	<u>XXXXX</u>	XXXXX

Provision for Corporate Dividend Tax should be disclosed separately under the head 'Provisions' in the balance sheet.

The accounting treatment for corporate dividend tax in the financial statements of a company can be explained with the help of following example:

X Co. Ltd. proposed dividend amounting to Rs. 500 lacs for the year ended 31st March, 2006. The corporate dividend tax liability of Rs. 50 lacs arises as per sections 115 O and 115 Q of the Income-tax Act. In this case, the charge for CDT should be disclosed separately in the Profit and Loss Account, below the line as given below:

	Rs. (lacs)	Rs. (lacs)
Proposed Dividend	500	
Corporate Dividend Tax	<u>50</u>	550

The provision for corporate dividend tax should be disclosed separately under, the head 'current liabilities and provisions'. The relevant extracts of the Balance Sheet of X Co. Ltd. can be shown as follows:

### Balance Sheet as on 31st March, 2006

Current liabilities and provisions:	
Proposed Dividend	500
Corporate Dividend Tax	50



**Illustration 4**

The following are the balances from the Ledger of Mount View Hotel Ltd., on 31st March 2006:

	Rs.
Share Capital - Credit Balance on 1st January, 2006	56,685
Preliminary Expenses	7,500
Freehold Premises	46,800
Furniture and Fittings	8,934
Glass and China	1,101
Linen	840
Cutlery and Plate	390
Rates, Taxes and Insurance	1,713
Salaries	2,400
Wages	4,305
Stocks on 31st March, 2005 :	
Wines, Rs. 1,239 ; Spirits, Rs. 378 ; Beer, Rs. 165 ;	1,782
Minerals, Rs. 147 ; Cigars and Cigarettes, Rs. 114	261
Sundry Provisions and Stores, Rs. 183; Coal, Rs. 150	333
Purchases :	
Meat, Rs. 3,627 ; Fish and Poultry Rs. 3,960	7,587
Sundry Provisions and Stores, Rs. 5,220	5,220
Wines Rs. 1,881 ; Spirits Rs. 2,190 ; Beer Rs. 1,152	5,223
Minerals, Rs. 1,050 : Cigars and Cigarettes, Rs. 240	1,290
Laundry	951
Coal and Gas	2,160
Electric Light	1,128
General Expenses	1,710
Sales —	



## Advanced Accounting

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Wines, Rs. 3,870 ; Spirits, Rs. 4,335 ; Beer, Rs. 1,863	10,068
Minerals, Rs. 2,160 ; Cigars and Cigarettes, Rs. 390	2,550
Meals	23,829
Rooms	9,375
Fires in Bedrooms	582
Washing Charges	219
Repairs, Renewals, and Depreciation -	
Premises, Rs. 348 ; Furniture and Fittings, Rs. 660	1,008
Glass and China, Rs. 609 ; Linen, Rs. 390	999
Cutlery and Plate	207
Cash Book - Debit Balances:	Rs.
In Bank	2,148
On hand	219
Visitors Accounts unpaid	489
Sundry Creditors	3,390
Stocks on 31st March, 2006 were valued as follows -	
Wines, Rs. 1,197; Spirits, Rs. 333 ; Beer, Rs. 174 ;	
Minerals, Rs. 357 ; Cigars and Cigarettes, Rs. 69 ;	
Sundry Provisions and Stores, Rs. 141 ; Coal, Rs. 99	

The Manager is entitled to a commission of 5% of the net profits *after* charging his commission. The authorised share capital is 10,000 shares of Rs. 10 each of which 5,700 shares were issued, the whole of the amount being called up. The final call on 210 shares @ Rs. 1.50 per share was unpaid ; the directors forfeited these shares at their meeting held on 15th March, 2006.

The tax liability is estimated at Rs. 4,300 and the directors propose to declare a dividend at the rate of 6 per cent. Prepare the Final Accounts for presentation to the shareholders.



Solution :

Profit and Loss Account of Mount-View Hotel Ltd.,  
for the year ended 31st March, 2006

	Rs.		Rs.
To	Opening Stocks -	By Sales -	
	Wines, Spirit and Beer	Wines, Spirits, Beer	10,068
	Minerals, Cigars and Cigarettes	Minerals, Cigars and	
	Sundry Provision & Stores and	Cigarettes	2,550
	Coal	By Meals	23,829
To	Purchases :	By Rooms	9,375
	Meat, Fish and Poultry	By Fires in Bed Rooms	582
	Sundry Provisions & Stores	By Washing Charges	219
	Wines, Spirits, Beer	By Closing Stocks :	
	Minerals, Cigars & Cigarettes	Wines, Spirit & Beer	1,704
To	Wages	Minerals, Cigars & Cigarettes	426
To	Coal and Gas	Sundry Provisions &	
To	Rates, Taxes and Insurances	Stores and Coal	240
To	Salaries		
To	Laundry		
To	Electricity Light		
To	General Expenses		
To	Repairs, Renewals and		
	Depreciation :		
	Premises		
	Furniture & Fittings		
	Glass and China		
	Linene		





## Advanced Accounting

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	Cutlery & Plate	207	
To	Commission to Manager		
	Outstanding (on Rs. 10,206 @ 5%)	510	
To	Provision for Taxation	4,300	
To	Net Profit Transferred to Profit & Loss Appropriation Account	<u>5,906</u>	_____
		<u>48,993</u>	<u>48,993</u>
To	Proposed Dividend 5,906	3,294	By Net Profit for the current year
To	Corporate Dividend Tax (3,294 × .10)	329.4	
To	Balance c/d	<u>2282.6</u>	
		<u>5,906</u>	<u>5,906</u>

### Balance Sheet of Mount-View Hotel Ltd., as on 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital :</i>		<i>Fixed Assets :</i>	
Authorised		Freehold Premises	47,148
10,000 Shares of Rs. 10 each	<u>1,00,000</u>	Less : Depreciation	<u>348</u> 46,800
<i>Issued &amp; Subscribed :</i>			
5,490 Equity Shares of Rs. 10 each fully paid up	54,900	Furniture & Fittings	9,594
Forfeited Shares	1,785	Less : Depreciation	<u>600</u> 8,934
<i>Reserves and Surplus :</i>		<i>Current Assets, Loans and Advances :</i>	
Profit & Loss Account	2282.6	(A) Current Assets :	
<i>Current Liabilities and Provisions</i>		Linen	1,230
(A) Current Liabilities :		Less : Depreciation	<u>390</u> 840
Sundry Creditors	3,390		



## Company Accounts

Manager's Commission Outstanding                      510 (B) Provisions : Provision for Taxation            4,300 Proposed Dividend                3,294 Corporate Dividend Tax        329.4	Cutlery & Plate                      597 <i>Less</i> : Depreciation <u>207</u> 390 Glass & China                        1,710 <i>Less</i> : Depreciation <u>609</u> 1,101 Stock of : Wines, Spirits & Beer                1,704 Minerals, Cigars & Cigarettes      426 Sundry Provisions & Stores and Coal                                240 Debtors                                 489 Cash in hand                         219 Cash at Bank                         2,148 (B) Loans & Advances :            Nil <i>Miscellaneous Expenditure</i> : Preliminary Expenses <u>7,500</u>
<u>70,791</u>	<u>70,791</u>

### Illustration 5

The following balances have been extracted from the books of DOW Books Limited as on 31st March, 2006.

Dr.	<i>Rs.</i>	Cr.	<i>Rs.</i>
Cash in hand	3,800	Share Capital	90,000
Cash at Bank	12,600	9% Debentures	30,000
Bills Receivable	4,000	Sundry Creditors	29,000
Investment	1,000	Profit and Loss A/c	2,000
Security Deposit	400	Secured Loan from bank	
Advances	8,500	against stock	50,000



## Advanced Accounting

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Debtors	75,000	Gross Profit	1,75,000
Land and Buildings	1,05,000	Share Suspense	3,000
Furniture	4,500	Liabilities for expenses	12,000
Motor Car	25,000	Sale of Furniture	300
Closing Stock	95,000	Bills Payable	3,100
Establishment expenses	35,200	Miscellaneous Receipts	425
Repairs and renewals	2,600		
Motor Car Expenses	4,200		
Travelling and Conveyance	1,600		
Printing and Stationery	900		
Telephone	1,200		
Debenture Interest	2,025		
Commission on sales	3,200		
Advertisement	3,500		
Managing Director's remuneration	3,600		
Directors fees	<u>2,000</u>		
	<u>3,94,825</u>		<u>3,94,825</u>

The following further particulars are available :

- (1) Amount of share capital has been arrived at as follows -

9,200 equity shares of Rs. 10 each, fully called up	92,000
Less : Calls-in-arrear @ Rs. 2 on 1,000 shares	<u>2,000</u>
	<u>90,000</u>
- (2) The Profit and Loss Account balance has been arrived at after charging Rs. 5,000 on account of short provision of taxation for the earlier year.
- (3) A Bank advice, for debit of Rs. 710 on account of interest on loan upto 31st March 2006, was received on 5th April, 2006 the loan having been taken on 1st March, 2006.
- (4) The Bank statement shows a wrong credit of Rs. 3,000 on 16th March 2006, the same being detected and adjusted by the Bank on 30th April 2006.



## Company Accounts

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- (5) The 1,000 shares, on which calls were forfeited by the Board, and Share Suspense represents the amount received on their reissue, as fully paid, by Board's resolution.
- (6) Sale of furniture represents disposals, during the year, of a few old items of furniture having a written-down value of Rs. 400 on 30th September 2006, against their original cost of Rs. 800.
- (7) Cost of land Rs. 30,000 is included in the amount of land and buildings.
- (8) Sundry debtors, which are all unsecured and considered goods, include Rs. 10,000 due for more than six months.
- (9) Advertisement charges include materials of Rs. 1,500.
- (10) Advances include Rs. 3,000 paid for a new telephone installed during the year under the OYT Scheme, of which an amount of Rs. 150 has been set off against the current year's bills.
- (11) Amounts of Rs. 2,000 and Rs. 1,200 debited to purchases and wages respectively, were for making new furniture during the year.
- (12) Investment represents purchase of 200 equity shares of Rs. 10 each, Rs. 5 per share called and paid up.
- (13) Charge depreciation on the closing written down amount of -
- |           |        |
|-----------|--------|
| Buildings | @ 2.5% |
| Furniture | @ 10%  |
| Motor Car | @ 20%  |
- (14) Original costs of fixed assets were -
- |           |          |
|-----------|----------|
|           | Rs.      |
| Buildings | 1,00,000 |
| Furniture | 9,000    |
| Motor Car | 35,000   |
- (15) The Managing Director is entitled to 5% of the annual net profits as his remuneration, subject to a minimum of Rs. 300 per month. The net profits, for this purpose, are to be taken without charging income-tax and his remuneration itself.
- (16) Bills discounted not matured Rs. 1,500.



## Advanced Accounting

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- (17) Provision for income-tax is to be made, for the year, of Rs. 65,000.
- (18) The following appropriations have been proposed by the Board of Directors out of the profit for the year -
- (a) Transfer of Rs. 20,000 to General Reserve.
  - (b) Dividend of 12% on the paid-up capital.
- (19) Debentures were issued two years back, and are not secured.

You are required to prepare the Profit and Loss Account for the year ended 31st March, 2006 and the Balance as on that date. Ignore previous year's figures.

**Solution :**

### DOW Books Ltd.

#### Profit and Loss Account for the Year ended 31st March, 2006

	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	
To	Establishment Expenses	35,200	By	Gross Profit	1,75,000
To	Repairs, Renewals	2,600	By	Cost of furniture, (expenses	
To	Motor Car Expenses	4,200		to be capitalised)	3,200
To	Travelling & Conveyance	1,600	By	Miscellaneous Receipts	425
To	Loss on sale of furniture	100			
To	Printing & Stationery	900			
To	Telephone	1,350			
To	Debenture Interest	2,700			
To	Bank Interest	710			
To	Commission on Sales	3,200			
To	Advertisement	2,000			
To	Directors' Fees	2,000			
To	Depreciation :				
	Furniture	730			
	Buildings	1,875			



## Company Accounts

	Motor Car	<u>5,000</u>	7,605	
To	Managing Director's Remuneration		5,723	
To	Provision for Income Tax		65,000	
*To	Short Provision for Income tax in the previous year		5,000	
To	Net Profit c/d	<u>38,737</u>		
		<u>1,78,625</u>		<u>1,78,625</u>
		Rs.		Rs.
To	Transfer to General Reserve (Proposed)		20,000	By Net Profit for the year b/d By Balance from previous year
				38,737
				7,000
To	Proposed Dividend		11,040	
To	Corporate Dividend Tax (11,040 × .10)		1104	
To	Balance c/d	<u>13,593</u>		
		<u>45,737</u>		<u>45,737</u>

\*The excess tax liability is to be considered as change in accounting estimate and the effect of such change should be included in the determination of net profit or loss of the affected period, in accordance with para 23 of AS 5 (Revised).

<b>Note on Remuneration to Managing Director:</b>	Rs.
Profit as disclosed	43,737
<i>Add :</i> Provision for Taxation	65,000
Managing Director's Remuneration	<u>5,723</u>
Profit before calculating the Remuneration	<u>1,14,460</u>
Remuneration @ 5%      5,723	



## Advanced Accounting

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### Balance Sheet of DOW Books Ltd., as at 31st March, 2006

<i>Liabilities and Capital</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
Share Capital		?	Fixed Assets :		
Authorised		?	Land at cost		30,000
Issued			Building : Cost	1,00,000	
Subscribed and Paid up :			Depreciation		
9,200 Equity Shares of Rs. 10			provided	<u>26,875</u>	73,125
each fully paid	92,000		Furniture : Cost	9,000	
<i>Reserve and Surplus</i>			Less : Disposed of		
Capital Reserve		1,000	(cost)	<u>800</u>	
Profit & Loss Account Balance		13,593		8,200	
General Reserve (Proposed			Addition during the		
Transfer)		20,000	year	<u>3,200</u>	
<i>Secured Loans</i>				11,400	
Loan from bank (secured			Depreciation provided	<u>4,830</u>	6,570
against stock) :	50,000		Motor Car		
Interest due	<u>710</u>	50,710	Cost	35,000	
<i>Unsecured Loans</i>			Depreciation provided	<u>15,000</u>	<u>20,000</u>
9% Debentures		30,000			
<i>Current Liabilities and Provisions :</i>					
<i>A. Current Liabilities</i>					
Bills Payable		3,100	<i>Investments :</i>		
Sundry Creditors for goods			Partly paid shares		1,000
and expenses		43,123	<i>Current Assets, Loans and</i>		
Interest accrued on Debentures		675	<i>Advances</i>		
<i>B. Provisions :</i>			<i>Current Assets :</i>		



## Company Accounts

Provision for Taxation	65,000	Stock in Trade (at cost)	95,000
Proposed Dividend	11,040	(Book Debts all un-	
Corporate Dividend Tax	11,04	secured but considered	
		good) More than	
		6 months 10,000	
		Others 65,000	75,000
		Cash in hand	3,800
		Cash at Bank (Bank ass-	
		umed to be Scheduled)	<u>12,600</u> 1,86,400
		B. <i>Advances</i> :	
		Bills Receivable	4,000
		Deposits	8,350
		Advertisement	
		Material on hand	1,500
		Security Deposit	<u>400</u> <u>14,250</u>
	<u>3,31,345</u>		<u>3,31,345</u>

**Note :** There is contingent liability for calls that may be made on partly paid shares, Rs. 1,000 and for Bills under discount, Rs. 1,500.

### Working Notes :

- (i) Rs. 710, interest due to Bank, may also be adjusted against the bank balance, specially when the Bank is entitled to debit to company's accounts under the Loan Agreement.
- (ii) The wrong credit given by the Bank, subsequently adjusted, is only an item for the Bank Reconciliation Statement.
- (iii) The Share Suspense Account has a balance of Rs. 1,000 after adjustment of the amount in arrear. It has to be credited to Capital Reserve.
- (iv) Rs. 150 out of OYT deposit has to be treated as telephone charges.
- (v) Previous year's figures have not been given since these are not available. Stastical information required to be disclosed under Schedule VI has also not been given for the same reason.





## Advanced Accounting

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### Illustration 6

You are required to prepare a Profit and Loss Account and Balance Sheet from the following Trial Balance extracted from the books of the International Hotels Ltd., on 31st March, 2006-

	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
Authorised Capital-divided into 5,000 6% Preference Shares of Rs. 100 each and 10,000 equity Shares of Rs. 100 each		<u>15,00,000</u>
Subscribed Capital - 5,000 6% Preference Shares of Rs. 100 each		5,00,000
Equity Capital		8,05,000
Purchases - Wines, Cigarettes, Cigars, etc.	45,800	
- Foodstuffs	36,200	
Wages and Salaries	28,300	
Rent, Rates and Taxes	8,900	
Laundry	750	
Sales - Wines, Cigarettes, Cigars, etc.		68,400
- Food		57,600
Coal and Firewood	3,290	
Carriage and Cooliage	810	
Sundry Expenses	5,840	
Advertising	8,360	
Repairs	4,250	
Rent of Rooms		48,000
Billiard		5,700
Miscellaneous Receipts		2,800
Discount received		3,300
Transfer fees		700
Freehold Land and Building	8,50,000	



## Company Accounts

Furniture and Fittings		86,300	
Stock on hand, 1st April, 2005			
Wines, Cigarettes. Cigars, etc.		12,800	
Foodstuffs		5,260	
Cash in hand		2,200	
Cash with Bankers		76,380	
Preliminary and formation expenses		8,000	
2,000 Debentures of Rs. 100 each (6%)			2,00,000
Profit and Loss Account			41,500
Sundry Creditors			42,000
Sundry Debtors		19,260	
Investments		2,72,300	
Goodwill at cost		5,00,000	
General Reserve			<u>2,00,000</u>
		<u>19,75,000</u>	<u>19,75,000</u>
Wages and Salaries Outstanding	1,280		
Stock on 31st March, 2006			
Wines Cigarettes and Cigars, etc.	22,500		
Foodstuffs	16,400		

Depreciation :

Furniture and Fittings @ 5% p.a. : Land and Building @ 2% p.a.

The Equity capital on 1st April, 2005 stood at Rs. 7,20,000, that is 6,000 shares fully paid and 2,000 shares Rs. 60 paid. The directors made a call of Rs. 40 per share on 1st October 2005. A shareholder could not pay the call on 100 shares and his shares were then forfeited and reissued @ Rs. 90 per share as fully paid. The Directors propose a dividend of 8% on equity shares, transferring any amount that may be required from General Reserve. Ignore Taxation.



## Advanced Accounting

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**Solution :**

### Profit and Loss Account of International Hotels Ltd. for the year ended 31st March, 2006

	Rs.		Rs.	
To	Stock on 1st April, 2005		By Sales,	
	Wines, Cigarettes, Cigars etc.	12,800	Wines, Cigaretters, Cigars etc.	68,400
	Foodstuffs	5,260	By Food	57,600
To	Purchases -		By Rent of Rooms	48,000
	Wines, Cigarettes etc.	45,800	By Billiards	5,700
	Foodstuffs	36,200	By Miscellaneous Receipts	2,800
To	Wages and Salaries	28,300	By Discount Received	3,300
	<i>Add:</i> Wages and		By Transfer fees	700
	Salaries Outstanding	<u>1,280</u>	29,580 By Stock on 31st March, 2006 :	
To	Rent, Rates and Taxes	8,900	Wines Cigarettes Cigars, etc.	22,500
To	Laundry	750	By Foodstuffs	16,400
To	Coal and Firewood	3,290		
To	Carriage and Cooliage	810		
To	Sundry Expenses	5,840		
To	Advertising	8,360		
To	Repairs	4,250		
To	Interest on Debentures	12,000		
To	Depreciation on Furniture			
	and Fittings @ 5%	4,315		
	Land and Buildings @ 2%	17,000		
To	Net Profit c/d	<u>30,245</u>		
		<u>2,25,400</u>		<u>2,25,400</u>
To	Preference Dividend Payable	30,000	By Net Profit b/d	41,500



## Company Accounts

To Proposed Equity Dividend	64,000	By Net Profit for the year	30,245
	<u>        </u>	By General Reserve	<u>22,255</u>
	<u>94,000</u>		<u>94,000</u>

Balance Sheet of International Hotels Ltd. as on 31st March, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital :</i>		<i>Fixed Assets</i>	
Authorised :		Goodwill (Cost)	5,00,000
5,000 6% Preference shares	5,00,000	Freehold land &	
of Rs. 100 each		Buildings*	8,50,000
10,000 Equity shares of	10,00,000	Less : Depreciation	<u>17,000</u>
Rs. 100 each	15,00,000		8,33,000

\* The amount in respect of Land has to be shown separately.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Issued and Subscribed :		Furniture and Fittings	86,300
5,000 6% Preference Shares		Less : Depreciation	<u>4,315</u>
of Rs. 100 each	5,00,000	<i>Investments :</i>	2,72,300
8,000 Equity Shares of Rs. 100 each	8,00,000	<i>Current Assets, Loans and</i>	
<i>Reserves and Surplus :</i>		<i>Advances :</i>	
Capital Reserve**	5,000	<i>(A) Current Assets :</i>	
General Reserve	2,00,000	Stock :	
Less : Amount used to		Wines, Cigarettes &	
pay dividend	<u>22,255</u>	Cigars, etc.	22,500
		Foodstuffs	16,400
<i>Secured loans :</i>		Sundry Debtors	19,260
6% Debentures	2,00,000	Cash in hand	2,200

\*Profit on forfeited shares reissued



## Advanced Accounting

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Outstanding Interest on above	12,000	Cash with Bankers	76,380
<i>Current Liabilities and Provisions :</i>		<i>(B) Loans and Advances : Nil</i>	
<i>(A) Current Liabilities :</i>		<i>Miscellaneous Expenditure :</i>	
Sundry Creditors	42,000	Preliminary Expenses	8,000
Wages and Salaries Outstanding	1,280		
<i>(B) Provisions :</i>			
Proposed Dividend (pref. and equity)	<u>94,000</u>		
	<u>18,32,025</u>		<u>18,32,025</u>

### Illustration 7

From the following particulars furnished by Pioneer Ltd., prepare the Balance Sheet as at 31st March, 2006 as required by Part I, Schedule VI of the Companies Act. Give notes at the foot of the Balance Sheet as may be found necessary -

	<i>Debit</i>	<i>Credit</i>
	Rs.	Rs.
Equity Capital (Face value of Rs. 100)		10,00,000
Calls in Arrears	1,000	
Land	2,00,000	
Building	3,50,000	
Plant and Machinery	5,25,000	
Furniture	50,000	
General Reserve		2,10,000
Loan from State Financial Corporation		1,50,000
Stock :		
Finished Goods	2,00,000	
Raw Materials	<u>50,000</u>	2,50,000
Provision for Taxation		68,000
Sundry Debtors	2,00,000	



## Company Accounts

Advances	42,700	
Proposed Dividend		60,000
Profit and Loss Account		1,00,000
Cash Balance	30,000	
Cash at Bank	2,47,000	
Preliminary Expenses	13,300	
Loans (Unsecured)		1,21,000
Sundry Creditors (For Goods and Expenses)		<u>2,00,000</u>
	<u>19,09,000</u>	<u>19,09,000</u>

The following additional information is also provided :

- (1) Miscellaneous expenses included Rs. 5,000 audit fees and Rs. 700 for out of pocket expenses paid to the auditors.
- (2) 2,000 equity shares were issued for consideration other than cash.
- (3) Debtors of Rs. 52,000 are due for more than six months.
- (4) The cost of assets:

Building	Rs.4,00,000
Plant and Machinery	Rs.7,00,000
Furniture	Rs.62,500
- (5) The balance of Rs. 1,50,000 in the loan account with State Finance Corporation is inclusive of Rs. 7,500 for interest accrued but not due. The loan is secured by hypothecation of the Plant and Machinery.
- (6) Balance at Bank includes Rs. 2,000 with Perfect Bank Ltd., which is not a Scheduled Bank.
- (7) Bills receivable for Rs. 2,75,000 maturing on 30th June, 2006 have been discounted.
- (8) The company had contract for the erection of machinery at Rs. 1,50,000 which is still incomplete.



**Solution :**

<b>Pioneer Ltd.</b>					
<b>Balance Sheet as on 31st March, 2006</b>					
<i>Liabilities</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
<i>Share Capital</i>			<i>Fixed Assets</i>		
<i>Authorised</i>			Land	2,00,000	
.... Equity shares of			Building: Cost	4,00,000	
Rs. ... each			Less: Depreciation	<u>50,000</u>	3,50,000
<i>Issued &amp; subscribed:</i>			Plant & Machinery		
10,000 Equity			Cost	7,00,000	
Shares of Rs. 100			Less: Depreciation	<u>1,75,000</u>	
5,25,000					
each fully called up	10,00,000		Furniture: Cost	62,500	
(Of the above 2,000			Less: Depreciation	<u>12,500</u>	50,000
Equity Shares of			<i>Investment</i>		
Rs. 100 each have been			<i>Current Assets, Loans &amp; Advances</i>		
issued for consideration			<i>A. Current Assets</i>		
other than cash)			Stock in trade		
Less: calls in arrears	<u>1,000</u>	9,99,000	Finished goods	2,00,000	
<i>Reserves &amp; Surplus</i>			Raw Material	50,000	2,50,000
General Reserve		2,10,000	(a) Debts outstanding		
Profit & Loss Account		1,00,000	for a period		
<i>Secured Loans</i>			exceeding six		
<i>Loan from State</i>			months	52,000	
Financial Corporation		1,42,500	(b) Other Debts		
(Secured by hypothecation of			Less Provision	<u>1,48,000</u>	
Plant and Machinery)					
2,00,000					



## Company Accounts

<i>Unsecured Loan</i>	Cash in hand	30,000
Unsecured Loans	1,21,000 Cash at Bank	
	(a) <i>with Scheduled</i>	
<i>Current Liabilities &amp; Provisions</i>	<i>Banks</i>	2,45,000
	(b) <i>with others</i>	
	Perfect Bank Ltd.	<u>2,00,000</u>
<i>A. Current Liabilities</i>		
Sundry Creditors	2,00,000	
Interest accrued but not due on loans (SFC)	7,500	
<i>B. Provisions</i>		
Provision for taxation	68,000	
Proposed Dividend	<u>60,000</u>	
	<u>19,08,000</u>	
	<i>B. Loans &amp; Advances</i>	
	Advances	42,700
	<i>Misc. Expenses</i>	
	(to the extent not written off)	
	Preliminary Expenses	<u>13,300</u>
		<u>9,08,000</u>

**Notes:**

(a) Estimated amount of contract remaining to be executed on capital account and not provided for Rs. 1,50,000.\*

(b) Bills receivable discounted maturing on 31st June, 2006 amount to Rs. 2,75,000.

\* It has been assumed that the company had given this contract for purchase of machinery.

**Illustration 8**

Fruit Juice Ltd., Mumbai has factories at Ratnagiri (alphonso mango pulp) and Nagpur (Orange juice).

During the year ended 31st March, 2006, the following location wise revenue statements were furnished by the two factories (from which the total column has been compiled):

	Ratnagiri	Nagpur	Total
	Rs.	Rs.	Rs.
Opening stock :			
Work in process	24,000	12,000	36,000
Finished goods	<u>8,000</u>	<u>2,000</u>	<u>10,000</u>





## Advanced Accounting

	32,000	14,000	46,000
Raw material consumption	25,00,000	10,00,000	35,00,000
Employee cost	5,00,000	6,00,000	11,00,000
Power and Fuel	1,00,000	50,000	1,50,000
Consumable stores	15,000	7,000	22,000
Rates and taxes	14,000	9,000	23,000
Repairs to factory :			
Building	4,000	5,000	9,000
Machinery	80,000	50,000	1,30,000
Other assets	3,000	1,000	4,000
Other expenses	65,000	55,000	1,20,000
Depreciation	<u>1,00,000</u>	<u>90,000</u>	<u>1,90,000</u>
	34,13,000	18,81,000	52,94,000
Less : Closing stock			
Work in process	28,000	13,000	41,000
Finished goods	<u>5,000</u>	<u>8,000</u>	<u>13,000</u>
	<u>33,000</u>	<u>21,000</u>	<u>54,000</u>
Cost of goods transferred to marketing division	<u>33,80,000</u>	<u>18,60,000</u>	<u>52,40,000</u>

The marketing division furnishes you with the following information of its productwise revenue statement for the year ended 31st March, 2006 (from which the total column has been compiled):

	Mango pulp	Orange juice	Total
Opening stock :	12,000	5,000	17,000
Receipt during the year out of :			
Last year's despatch from factory	10,000	5,000	15,000
Current year's despatch from factory	<u>33,65,000</u>	<u>18,50,000</u>	<u>52,30,000</u>
	33,75,000	18,55,000	52,30,000
Transport "in" cost from factory	<u>50,000</u>	<u>60,000</u>	<u>1,10,000</u>
	34,37,000	19,20,000	53,57,000
Less : Closing stock	<u>7,000</u>	<u>10,000</u>	<u>17,000</u>
	34,30,000	19,10,000	53,40,000
Sales commission	5,00,000	2,50,000	7,50,000
Sales tax	4,00,000	1,25,000	5,25,000
Profit	<u>6,70,000</u>	<u>2,15,000</u>	<u>8,85,000</u>
Sales	<u>50,00,000</u>	<u>25,00,000</u>	<u>75,00,000</u>



## Company Accounts

You are asked to prepare sectional and consolidated revenue statement for the year ended 31st March, 2006 for consideration of the board of directors and presentation to the members of Fruit Juice Ltd. Also work out the percentage of net profit to sales.

Show your working, if any.

### Solution

#### Revenue Statement of Fruit Juice Ltd. (Sectional and Consolidated) for the year ended 31st March, 2006

	Mango Pulp Rs. '000	Orange Juice Rs. '000	Total Rs. '000
Sales	5,000	2,500	7,500
<i>Add: Excess of closing inventory over opening inventory (Working note 1)</i>	<u>1</u>	<u>17</u>	<u>18</u>
Gross revenue	5,001	2,517	7,518
<i>Less: Manufacturing and other expenses (Working note 2)</i>	<u>4,231</u>	<u>2,212</u>	<u>6,443</u>
Profit before depreciation	770	305	1,075
<i>Less: Depreciation</i>	<u>100</u>	<u>90</u>	<u>190</u>
Net Profit	<u>670</u>	<u>215</u>	<u>885</u>
	Mango Pulp	Orange Juice	Total
Percentage of net profit to sales	13.4%	8.6%	11.8%

### Working Notes :

(1) *Excess of closing inventory over opening inventory*

(a)	Mango Pulp Rs. '000	Orange Juice Rs. '000	Total Rs. '000
Opening Stock			
Finished goods :			
At factory	8	2	10
In transit (received during the year by marketing division)	10	5	15
With marketing division	<u>12</u>	<u>5</u>	<u>17</u>
	30	12	42
Work in process	<u>24</u>	<u>12</u>	<u>36</u>
Total	<u>54</u>	<u>24</u>	<u>78</u>



## Advanced Accounting

(b)	<i>Mango Pulp</i> Rs. '000	<i>Orange Juice</i> Rs. '000	<i>Total</i> Rs. '000
Closing Stock			
Finished goods :			
At factory	5	8	13
In transit*	15	10	25
With marketing division	7	10	17
	<u>27</u>	<u>28</u>	<u>55</u>
Work in process	<u>28</u>	<u>13</u>	<u>41</u>
	<u>55</u>	<u>41</u>	<u>96</u>
(c) Closing Stock	55	41	96
Less : Opening stock	<u>54</u>	<u>24</u>	<u>78</u>
Excess of closing stock over opening stock	<u>1</u>	<u>17</u>	<u>18</u>
*Goods sent by factory	3,380	1,860	5,240
Less : Received by marketing division	<u>3,365</u>	<u>1,850</u>	<u>5,215</u>
Finished goods in transit	<u>15</u>	<u>10</u>	<u>25</u>
 (2) <i>Manufacturing and other costs</i>			
	<i>Mango Pulp</i> Rs. '000	<i>Orange Juice</i> Rs. '000	<i>Total</i> Rs. '000
Manufacturing costs:			
Raw Material consumption	2,500	1,000	3,500
Employee cost	500	600	1,100
Power and fuel	100	50	150
Consumable stores	15	7	22
Rates and taxes	14	9	23
Repairs : Building	4	5	9
Machinery	80	50	130
Other assets	3	1	4
Other costs :			
Transport	50	60	110
Sales commission	500	250	750
Sales tax	400	125	525
Other expenses	<u>65</u>	<u>55</u>	<u>120</u>
	<u>4,231</u>	<u>2,212</u>	<u>6,443</u>



### Recent Amendment to clause 32 vide circular dated 4th February, 2000

Stock exchanges were advised to amend Clause 32 of the listing agreement, *vide* circular No. SMD-I(N)/JJ/2331/95 dated 16th June, 1965 to provide that listed companies shall give a cash flow statement in the annual report and the following additional was made to the Clause 32 :

"The company will also give a cash flow statement along with the balance sheet and profit and loss account.."

With a view to harmonise the disclosure requirements under the listing agreement and the Accounting Standard issued by Institute of Chartered Accountants of India (ICAI), clause 32 has been amended *vide* circular dated 4th February, 2000. It has been decided that the cash flow statement being disclosed in terms of Listing Agreement shall henceforth be prepared in accordance with the Accounting Standard on cash flow statement (AS-3) issued by ICAI and the relevant portion of the clause 32 shall be amended as follows :

"The cash flow statement will be prepared in accordance with the Accounting Standard on cash flow statement (AS-3) issued by the Institute of Chartered Accountants of India and the cash flow statement shall be presented only under the indirect method as given in AS-3".

Students may note that, Cash flow statement has been discussed in the next unit.

### Self-examination questions

#### I. Objective Type Questions

Choose the appropriate answer from the given options

1. Dividends are usually paid on:
  - (a) Paid-up Capital
  - (b) Authorised Capital.
  - (c) Called-up Capital
2. Amount set aside to meet losses due to bad debts is a:
  - (a) Reserve
  - (b) Provision
  - (c) Liability.



## Advanced Accounting

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3. Securities Premium Account is shown on the liabilities side in the Balance Sheet under the heading:
  - (a) Reserves and Surplus.
  - (b) Current Liabilities and Provisions.
  - (c) Share Capital.
4. If the proposed dividend is 20% the percentage of profits to be transferred to reserve is:
  - (a) 2.5%
  - (b) 5%
  - (c) 7.5%
5. Indicate the item that appears in the Profit and Loss Account below the line:
  - (a) Proposed Dividend.
  - (b) Provision for Taxation
  - (c) Contribution to Provident Fund.
6. Rate of corporate dividend tax is:
  - (a) 10%
  - (b) 8%
  - (c) Nil.

**Ans.** [1-(a); 2-(b); 3-(a); 4-(c); 5-(a); 6-(a)].

### II. Short Answer Type Questions

7. Who is responsible for maintenance of books of account? Briefly explain the provisions of company law regarding maintenance of proper books of account.
8. What do you mean by divisible profit? When can dividend be paid out of capital profits?

### III. Long Answer Type Questions

9. What are the various heads under which profits are usually appropriated by companies and for what reasons?

### IV. Practical Problems



## Company Accounts

10. The engineer of sugar mill is entitled to a commission of 5% of the net profit of the mill; the chemist of the mill is also entitled to a commission of 4% of the net profit which in each case is to be calculated after charging the commission payable to the other person but before charging one's own commission. What is the amount payable to each if the net profit of the mill before the two commission is Rs. 5,00,000?
11. The following is the draft Profit & Loss Account of the Paper Company of India Ltd. for the year ending 31st March, 2006 :

	Rs.		Rs.
To Administrative, Selling		By Balance b/d	3,12,632
To Finance Expenses	5,73,804	By Balance from Trading	
To National Defence Fund	18,800	Account	38,35,414
To Directors' Fees	23,484	By Interest on Investments	10,964
To Interest on Debentures	2,824	By Transfer fee	37
To Managing Director's			
Remuneration	1,40,000	By Profit on sale of plant:	Rs.
To Depreciation on fixed assets	4,69,713	By Amount realised	40,000
To Provision for taxation	11,40,000	Less Book value	
To General Reserve	5,00,000	(Cost Rs. 35,000)	<u>31,000</u>
To Debentures Sinking Fund	4,800		9,000
To Investment Revaluation Reserve	9,800		
To Balance c/d	<u>12,84,822</u>		
	<u>41,68,047</u>		<u>41,68,047</u>

As an auditor you are required to comment on the managerial remuneration.

12. Bee Ltd. had the following Balance on 31-03-2006:

	Rs.
6% Preference Shares of Rs. 25 each fully paid	2,00,000
Equity Shares of Rs. 100 each fully paid	10,00,000
Share Premium Account	2,00,000



## Advanced Accounting

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Capital Redemption Reserve Account	1,00,000
General Reserve	3,00,000
Profit and Loss Account	80,000

On the date, Land and Building which stood at Rs. 5,00,000 in the books were revalued at Rs. 8,00,000. It was decided to

- (i) consolidate the preference shares into shares of Rs. 100 each;
- (ii) subdivide the equity shares of Re. 1 each;
- (iii) adopt the revaluation of Land and Building; and
- (iv) issue fully paid up bonus shares to equity shareholders equal to 50% of the present Equity Share Capital, revenue reserve and profit being used only if necessary for the purpose.

Give journal entries to record the above and state the reserve and profits that remain.



**Unit – 2 : Cash Flow Statements**

**Learning Objectives**

After studying this unit, you will be able to:

- ◆ Define cash flow statement as per AS 3
- ◆ Differentiate operating, investing and financing activities
- ◆ Learn the various elements of cash and cash equivalents
- ◆ Prepare cash flow statement both by direct method and indirect method.

**2.1 INTRODUCTION**

Accounting Standard 3, Cash Flow Statements, was issued in March, 2004. This revised Accounting Standard superseded the Accounting Standard (AS 3) on changes in Financial Position, issued in June 1981.

Cash flow statement provides information about the changes in cash and cash equivalents of an enterprise. Cash flow statement is based on cash concept of profit. Cash flow statement seems to be useful because it identifies cash generated from trading operations, the operating cash surplus which can be applied for investment in fixed assets. In fact a portion of cash from operations is used to pay dividend and tax and the other portion is ploughed back. What can be ploughed back is directly identifiable from cash flow statement. In projected form, this statement is a very useful tool of planning.

Cash flow statements are prepared to explain the cash movements between two points of time.

*Sources of Cash:*

1. Issue of shares and debentures and raising long-term loan.
2. Sale of investments and other fixed assets.
3. Cash from operations.
4. Decrease in Cash.

*Applications of Cash:*

1. Redemption of preference shares and debentures and repayment of long-term loan.





2. Purchase of investments and other fixed assets.
3. Payment of tax.
4. Payment of dividend.
5. Increase in cash.

Increase in cash or decrease in cash is put in the applications and the sources respectively just to balance the cash flow statement. At this juncture students may note that in cash flow statement changes in all balance sheet items are to be taken into consideration separately for explaining movement of cash.

### 2.2 ELEMENTS OF CASH FUND

As per AS 3, issued by the Council of the ICAI, 'Cash Funds' include:

- (i) Cash in hand,
- (ii) Demand deposits with banks, and
- (iii) Cash equivalents.

Cash equivalents which are considered as part of funds for calculation of cash flows are defined as 'short term highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value'. Basic objective of acquisition of cash equivalents is to deploy, for a short period, idle cash required to meet short-term cash-commitments. Securities with short maturity period of, say, three months or less from the date of acquisition qualify as a cash equivalent. Examples are: acquisition of preference shares, shortly before their specified redemption date, bank deposits with short maturity period, etc. Thus, cash flow statement deals with flow of cash funds but does not consider the movements among cash, bank balance payable on demand and investment of excess cash in cash equivalents. Examples are cash withdrawn from current account, cash deposited in bank for 60 days, etc.

### 2.3 CLASSIFICATION OF CASH FLOW ACTIVITIES

Transactions, which increase cash, are classified as cash inflow and transactions which decrease cash are classified as cash outflow. Thus, cash flow statement provides explanation for changes in cash position of the business entity. Accounting Standard issued by the Institute of Chartered Accountants of India require that the cash flow statement should report cash flows during the period classified by operating, investing and financing activities:

**2.3.1 Operating Activities:** These are the principal revenue producing activities of the enterprise. Net impact of operating activities on flow of cash is reported as 'Cash flows from operating activities' or 'cash from operation'.



The amount of cash flows from operating activities is a key indicator of the extent to which the operations of the enterprises have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans, and make new investments without recourse to external sources of financing. It provides useful information about internal financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.

**2.3.2 Investing activities:** These are the acquisition and disposal of long-term assets and other investments not included in cash equivalents. The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which the expenditures have been made for resources intended to generate future incomes and cash flows.

**2.3.3 Financing activities:** These are the activities that result in changes in the size and composition of the owner's capital (including preference share capital) and borrowings of the enterprise. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise.

## 2.4 CALCULATION OF CASH FLOWS FROM OPEATING ACTIVITIES

Cash flows from operating activities result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flow from operations include cash receipts from the sale of goods and the rendering of services; cash receipt from fees, commission and other revenue; cash payments to suppliers for goods; cash payments to employees and so on. An enterprise can determine cash flows from operating activities using either:

The direct method, whereby major classes of gross cash receipts and gross cash payments are considered; or the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing activities.

**2.4.1 Direct Method:** Under the direct method, information about gross receipts and gross cash payments may be obtained from the accounting records to ascertain cash flows from operating activities. For example, information about cash received from debtors, payment to creditors, cash expenses etc., may be obtained by an analysis of cash book. In actual practice, the relevant information is obtained by adjusting sales, cost of sales and other items in the profit and loss accounts for:

- ◆ Changes during the period in inventories and operating receivables and payables;



## Advanced Accounting

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- ◆ Other non-cash items such as depreciation on fixed assets, goodwill written off, preliminary expenses written off, loss or gain on sale of fixed assets etc.; and
- ◆ Other items for which the cash effects are investing or financing cash flows. Examples are interest received and paid, dividend received and paid etc., which are related to financing or investing activities and are shown separately in the cash flow statement.

This procedure of computation of cash flows from operating activities is also known as income statement method. The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. However, indirect method of determining the cash from operating activities is more popular in actual practice.

**2.4.2 Indirect Method:** Under the indirect method, the net cash from operating activities is determined by adjusting net profit or loss instead of individual items appearing in the profit and loss account. Net profit or loss is also adjusted for the effect of:

- (a) changes during the period in inventories and operating receivables and payables;
- (b) non-cash items such as depreciation; and
- (c) all other items for which the cash effects are financing or investing cash flows.

The indirect method is also known as 'reconciliation method'. It is worth noting that both direct and indirect methods adjust current assets and current liabilities related to operating activities to determine cash from operating activities. But direct method adjust individual items of profit and loss account and indirect method adjusts overall net profit (or loss) to determine cash from operation. Therefore, indirect method fails to provide break-up of cash from operations.

Proforma of 'Cash Flow From Operating Activities' by indirect method:

	Rs.
Net Profit for the year	-
<i>Add: Non-Cash Expenses:</i>	-
Depreciation	-
Share Discount Written off	-
Loss on Sale of Assets	-
Provision for taxation, etc.	-
<i>Less: Non-Cash Incomes:</i>	-
Profit on Sale of Assets	-
Net Profit after Adjustment for Non-Cash Items	(-)



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## Company Accounts

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Cash from operation	=	Net Profit (after adjustment for Non-cash Items)
	-	Increase in Current Assets
	+	Decrease in Current Asset
	+	Increase in Current Liabilities
	-	Decrease in Current Liability

### 2.5 CALCULATION OF CASH FLOWS FROM INVESTING ACTIVITIES

These activities are related to the acquisition and disposal of long-term assets, non-operating current assets and investments which results in outflow of cash. Disposal of the aforesaid assets results in inflow of cash. Thus, inflows and outflows related to acquisition and disposal of assets, other than those related to operating activities, are shown under this category

### 2.6 CALCULATION OF CASH FLOWS FROM FINANCING ACTIVITIES

These activities are basically related to the changes in capital and borrowing of the enterprise which affect flow of cash. Redemption of shares and repayment of borrowings results in outflow of cash. Thus inflows and outflows related to the amount of capital and borrowings of the enterprise are shown under this head.

Students are advised to refer full text of revised Accounting Standard on Cash Flow Statements (AS 3) for the better understanding of the chapter.

#### Illustration 1

The following summary cash account has been extracted from the company's accounting records:

#### Summary Cash Account

		<i>(Rs. '000)</i>
Balance at 1.1.2006		35
Receipts from customers		2,783
Issue of shares		300
Sale of fixed assets		<u>128</u>
		3,246
Payments to suppliers	2,047	
Payments for fixed assets	230	
Payments for overheads	115	



## Advanced Accounting

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Wages and salaries	69	
Taxation	243	
Dividends	80	
Repayments of bank loan	<u>250</u>	<u>(3,034)</u>
Balance at 31.12.2006		<u>212</u>

Prepare Cash Flow Statement of this company Hills Ltd. for the year ended 31st December 2006 in accordance with AS-3 (Revised).

The company does not have any cash equivalents.

### Solution

**Hills Ltd.**  
**Cash Flow Statement for the year ended 31st December 2006**  
**(Using the direct method)**

*(Rs. '000)*

<b>Cash flows from operating activities</b>		
Cash receipts from customers	2,783	
Cash payments to suppliers	(2,047)	
Cash paid to employees	(69)	
Other cash payments (for overheads)	<u>(115)</u>	
Cash generated from operations	552	
Income taxes paid	<u>(243)</u>	
<i>Net cash from operating activities</i>		309
<b>Cash flows from investing activities</b>		
Payments for purchase of fixed assets	(230)	
Proceeds from sale of fixed assets	<u>128</u>	
<i>Net cash used in investing activities</i>		(102)
<b>Cash flows from financing activities</b>		
Proceeds from issuance of share capital	300	
Bank loan repaid	(250)	
Dividend paid	<u>(80)</u>	
<i>Net cash used in financing activities</i>		<u>(30)</u>
<b>Net increase in cash and cash equivalents</b>		177
<b>Cash and cash equivalents at beginning of period</b>		<u>35</u>
<b>Cash and cash equivalents at end of period</b>		212



## Company Accounts

The solution given in above illustration has been prepared using simply the summarised cash account. To teach the technique of preparing Cash Flow Statement from comparative balance sheets and profit and loss account, the above illustration has been expanded by giving following further detailed information extracted from the records of Hills Ltd.

### Illustration 2

The following data were provided by the accounting records of Ryan Ltd. at year-end, March 31, 2006:

#### Income Statement

		Rs.
Sales		6,98,000
Cost of Goods Sold		<u>(5,20,000)</u>
Gross Margin		1,78,000
Operating Expenses (including Depreciation Expense of Rs. 37,000)		<u>(1,47,000)</u>
		31,000
Other Income (Expenses)		
Interest Expense paid	(23,000)	
Interest Income received	6,000	
Gain on Sale of Investments	12,000	
Loss on Sale of Plant	<u>(3,000)</u>	
		<u>(8,000)</u>
		23,000
Income tax		<u>(7,000)</u>
		<u>16,000</u>

#### Comparative Balance Sheets

	31st March 2006	31st March 2005
Assets	7,15,000	5,05,000
Plant Assets	<u>(1,03,000)</u>	<u>(68,000)</u>
Less: Accumulated Depreciation	6,12,000	4,37,000
Investments (Long term)	1,15,000	1,27,000
Current Assets:	1,44,000	1,10,000
Inventory	47,000	55,000
Accounts Receivable	46,000	15,000



## Advanced Accounting

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Cash	<u>1,000</u>	<u>5,000</u>
Prepaid Expenses	<u>9,65,000</u>	<u>7,49,000</u>
<i>Liabilities</i>		
Share Capital	4,65,000	3,15,000
Reserves and Surplus	1,40,000	1,32,000
Bonds	2,95,000	2,45,000
Current Liabilities:		
Accounts Payable	50,000	43,000
Accrued Liabilities	12,000	9,000
income Taxes Payable	<u>3,000</u>	<u>5,000</u>
	<u>9,65,000</u>	<u>7,49,000</u>

Analysis of selected accounts and transactions during 2005-2006

1. Purchased investments for Rs. 78,000
  2. Sold investments for Rs. 1,02,000.  
These investments cost Rs. 90,000
  3. Purchased plant assets for Rs. 1,20,000
  4. Sold plant assets that cost Rs. 10,000 with  
accumulated depreciation of Rs. 2,000 for Rs. 5,000.
  5. Issued Rs. 1,00,000 of bonds at face value in an exchange for  
plant assets on 31st March, 2006
  6. Repaid Rs. 50,000 of bonds at face value at maturity.
  7. Issued 15,000 shares of Rs. 10 each.
  8. Paid cash dividends Rs. 8,000.
- Prepare Cash Flow Statement as per AS-3 (Revised), using indirect method.



Solution

	<i>Rs.</i>	<i>Rs.</i>
<b>Cash flows from operating activities</b>		
Net profit before taxation	23,000	
Adjustments for:		
Depreciation	37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Interest expense	23,000	
Interest income	<u>(6,000)</u>	
Operating profit before working capital changes	68,000	
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	<u>3,000</u>	
Cash generated from operations	56,000	
Income taxes paid*	<u>(9,000)</u>	
<i>Net cash from operating activities</i>		47,000
<b>Cash flows from investing activities</b>		
Purchase of plant assets	(1,20,000)	
Sale of plant assets	5,000	
Purchase of investments	(78,000)	
Sale of investments	1,02,000	
Interest received	<u>6,000</u>	
<i>Net cash used in investing activities</i>		(85,000)
<b>Cash flows from financing activities</b>		
Proceeds from issuance of share capital	1,50,000	
Repayment of bonds	(50,000)	
Interest paid	(23,000)	





## Advanced Accounting

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Dividends paid	(8,000)	
<i>Net cash from financing activities</i>		<u>69,000</u>
Net increase in cash (and cash equivalents)		31,000
Cash (and cash equivalents) at beginning of period		<u>15,000</u>
Cash (and cash equivalents) at end of period		<u>46,000</u>

### \*Working Note:

	<i>Rs.</i>	
Income taxes paid:		
Income tax expense for the year	7,000	
<i>Add:</i> Income tax liability at the beginning of the year	<u>5,000</u>	
	12,000	
<i>Less:</i> Income tax liability at the end of the year	<u>3,000</u>	
	<u>9,000</u>	

### Illustration 3

The balance sheets of Sun Ltd. for the years ended 31st March 2006 and 2005 were summarised thus:

	<i>2006</i>	<i>2005</i>
	<i>Rs.</i>	<i>Rs.</i>
Equity Share Capital	60,000	50,000
Reserves:		
Profit and Loss Account	5,000	4,000
Current Liabilities:		
Creditors	4,000	2,500
Taxation	1,500	1,000
Proposed dividends	<u>2,000</u>	<u>1,000</u>
	<u>72,500</u>	<u>58,500</u>
Fixed Assets (at w.d.v.)		
Premises	10,000	10,000
Fixtures	17,000	11,000
Vehicles	12,500	8,000
Short-term investments	2,000	1,000



## Company Accounts

Current Assets		
Stock	17,000	14,000
Debtors	8,000	6,000
Bank and Cash	<u>6,000</u>	<u>8,500</u>
	<u>72,500</u>	<u>58,500</u>

and the profit and loss account for the year ended 31st March, 2006 disclosed

	<i>Rs.</i>
Profit before tax	4,500
Taxation	<u>(1,500)</u>
Profit after tax	3,000
Proposed dividends	<u>(2,000)</u>
Retained profit	<u>1,000</u>

Further information is available:

	<i>Vehicles</i>	<i>Fixtures</i>
	<i>Rs.</i>	<i>Rs.</i>
Depreciation for year	<u>1,000</u>	<u>2,500</u>
Disposals:		
Proceeds on disposal	—	1,700
Written down value	—	<u>(1,000)</u>
Profit on disposal		<u>700</u>

Prepare a Cash Flow Statement for the year ended 31st March, 2006.

### Solution

#### Sun Ltd.

#### Cash Flow Statement

for the year ended 31st March, 2006

	<i>Rs.</i>	<i>Rs.</i>
<b>Cash flows from operating activities</b>		
Net Profit before taxation	4,500	
Adjustments for:		
Depreciation	3,500	
Profit on sale of vehicles	<u>(700)</u>	
Operating profit before working capital changes	7,300	
increase in sundry debtors	<u>(2,000)</u>	



## Advanced Accounting

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Increase in inventories	(3,000)	
Increase in sundry creditors	<u>1,500</u>	
Cash generated from operations	3,800	
Income taxes paid	<u>(1,000)</u>	
<i>Net cash from operating activities</i>		2,800
<b>Cash flows from investing activities</b>		
Sale of vehicles	1,700	
Purchase of vehicles	(8,000)	
Purchase of fixtures	<u>(7,000)</u>	
<i>Net cash used in investing activities</i>		(13,300)
<b>Cash flows from financing activities</b>		
Issue of shares for cash	10,000	
Dividends paid	<u>(1,000)</u>	
<i>Net cash from financing activities</i>		<u>9,000</u>
<b>Net decrease in cash and cash equivalents</b>		1,500
<b>Cash and cash equivalents at beginning of period</b>		9,500
(See Note 1)		—
<b>Cash and cash equivalents at end of period</b>		<u>8,000</u>
(See Note 1)		

### Note to the Cash Flow Statement

#### *Cash and Cash Equivalents*

	31.3.2006	31.3.2005
Bank and Cash	6,000	8,500
Short-term investments	<u>2,000</u>	<u>1,000</u>
Cash and cash equivalents	<u>8,000</u>	<u>9,500</u>

#### Working Notes:

		Rs.
1. Income taxes paid		
Income tax expense for the year	1,500	
<i>Add:</i> Income tax liability at the beginning of the year	<u>1,000</u>	
		2,500
<i>Less:</i> Income tax liability at the		



## Company Accounts

end of the year	1,500	
	<u>1,000</u>	
2. Dividend paid		
Proposed dividend for the year	2,000	
<i>Add:</i> Amount payable at the beginning of the year		<u>1,000</u>
		3,000
<i>Less:</i> Amount payable at the end of the year		<u>2,000</u>
		<u>1,000</u>
3. Fixed assets acquisitions		
	<i>Fixtures</i>	<i>Vehicles</i>
	<i>Rs.</i>	<i>Rs.</i>
W.D.V. at 31.3.2006	17,000	12,500
<i>Add back:</i>		
Depreciation for the year	1,000	2,500
Disposals	<u>—</u>	<u>1,000</u>
	18,000	16,000
<i>Less:</i> W.D.V. at 31.12.2005	<u>11,000</u>	<u>8,000</u>
Acquisitions during 2005-2006	<u>7,000</u>	<u>8,000</u>

### Illustration 4

Ms. Joyti of Star Oils Limited has collected the following information for the preparation of cash flow statement for the year 2005 :

	<i>(Rs. in Lakhs)</i>
Net Profit	25,000
Dividend (including dividend tax) paid	8,535
Provision for Income tax	5,000
Income tax paid during the year	4,248
Loss on sale of assets (net)	40
Book value of the assets sold	185
Depreciation charged to Profit & Loss Account	20,000
Amortisation of Capital grant	6
Profit on sale of Investments	100
Carrying amount of Investment sold	27,765



## Advanced Accounting

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Interest income on investments	2,506
Increase expenses	10,000
Interest paid during the year	10,520
Increase in Working Capital (excluding Cash & Bank Balance)	56,075
Purchase of fixed assets	14,560
Investment in joint venture	3,850
Expenditure on construction work in progress	34,740
Proceeds from calls in arrear	2
Receipt of grant for capital projects	12
Proceeds from long-term borrowings	25,980
Proceeds from short-term borrowings	20,575
Opening cash and Bank balance	5,003
Closing cash and Bank balance	6,988

Required :

Prepare the Cash Flow Statement for the year 2005 in accordance with AS 3, Cash Flow Statements issued by the Institute of Chartered Accountants of India. (make necessary assumptions).

### Solution

#### Star Oils Limited

#### Cash Flow Statement

for the year ended 31st December, 2005

(Rs. in lakhs)

<b>Cash flows from operating activities</b>	
Net profit before taxation (25,000 + 5,000)	30,000
Adjustments for :	
Depreciation	20,000
Loss on sale of assets (Net)	40
Amortisation of capital grant	(6)
Profit on sale of investments	(100)
Interest income on investments	(2,506)
Interest expenses	10,000
Operating profit before working capital changes	57,428
Changes in working capital (Excluding cash and bank balance)	(56,075)
Cash generated from operations	1,353
Income taxes paid	(4,248)



## Company Accounts

Net cash used in operating activities	—————	(2,895)
<b>Cash flows from investing activities</b>		
Sale of assets	145	
Sale of investments (27,765 + 100)	27,865	
Interest income on investments	2,506	
Purchase of fixed assets	(14,560)	
Investment in joint venture	(3,850)	
Expenditure on construction work-in progress	(34,740)	
Net cash used in investing activities		(22,634)
<b>Cash flows from financing activities</b>		
Proceeds from calls in arrear	2	
Receipts of grant for capital projects	12	
Proceeds from long-term borrowings	25,980	
Proceed from short-term borrowings	20,575	
Interest paid	(10,520)	
Dividend (including dividend tax) paid	(8,535)	
	—————	27,514
Net increase in cash and cash equivalents		1,985
Cash and cash equivalents at the beginning of the period		5,003
Cash and cash equivalents at the end of the period		<u>6,988</u>

### Working note :

Book value of the assets sold	185
<i>Less</i> : Loss on sale of assets	40
Proceeds on sale	<u>145</u>

### Assumption :

Interest income on investments Rs. 2,506 has been received during the year.

### Illustration 5

From the following Summary Cash Account of X Ltd. prepare Cash Flow Statement for the year ended 31st March, 2006 in accordance with AS 3 (Revised) using the direct method. The company does not have any cash equivalents.



## Advanced Accounting

### Summary Cash Account for the year ended 31.3.2006

	<i>Rs. '000</i>		<i>Rs. '000</i>
Balance on 1.4.2005	50	Payment to Suppliers	2,000
Issue of Equity Shares	300	Purchase of Fixed Assets	200
Receipts from Customers	2,800	Overhead expense	200
Sale of Fixed Assets	100	Wages and Salaries	100
		Taxation	250
		Dividend	50
		Repayment of Bank Loan	300
		Balance on 31.3.2006	150
	<u>3,250</u>		<u>3,250</u>

Solution

X Ltd.

### Cash Flow Statement for the year ended 31st March, 2006

(Using direct method)

	<i>Rs. '000</i>	<i>Rs. '000</i>
<b>Cash flows from operating activities</b>		
Cash receipts from customers	2,800	
Cash payments to suppliers	(2,000)	
Cash paid to employees	(100)	
Cash payments for overheads	(200)	
Cash generated from operations	<u>500</u>	
Income tax paid	(250)	
Net cash from operating activities		250
<b>Cash flows from investing activities</b>		
Payments for purchase of fixed assets	(200)	
Proceeds from sale of fixed assets	<u>100</u>	
Net cash used in investing activities		(100)
<b>Cash flows from financing activities</b>		
Proceeds from issuance of equity shares	300	
Bank loan repaid	(300)	
Dividend paid	(50)	
Net cash used in financing activities		<u>(50)</u>



## Company Accounts

Net increase in cash	100
Cash at beginning of the period	50
Cash at end of the period	<u>150</u>

### Illustration 6

Given below is Profit and Loss Account of ABC Ltd. and relevant Balance Sheet information:

#### Profit and Loss Account of ABC Ltd. for the year ended 31st December, 2006

	<i>Rs. in lakhs</i>
Revenue:	
Sales	4,150
Interest and dividend	100
Stock adjustment	<u>20</u>
Total (A)	<u>4,270</u>
Expenditure:	
Purchases	2,400
Wages and salaries	800
Other expenses	200
Interest	60
Depreciation	<u>100</u>
Total (B)	<u>3,560</u>
Profit before tax (A – B)	710
Tax provision	<u>200</u>
Profit after tax	510
Balance of Profit and Loss account brought forward	<u>50</u>
Profit available for distribution (C)	<u>560</u>
Appropriations:	
Transfer to general reserve	200
Proposed dividend	300
Distribution tax	<u>30</u>
Total (D)	<u>530</u>
Balance (C – D)	30

*Relevant Balance Sheet information*

*31.12.2006*

*31.12.2005*





## Advanced Accounting

	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Debtors	400	250
Inventories	200	180
Creditors	250	230
Outstanding wages	50	40
Outstanding expenses	20	10
Advance tax	195	180
Tax provision	200	180
Assessed tax liability		

Compute cash flow from operating activities using both direct and indirect method.

### Solution

#### By direct method

#### Computation of Cash Flow from Operating Activities

	<i>Rs.</i>	<i>Rs.</i>
Cash Receipts:		
Cash sales and collection from debtors		
Sales + Opening debtors – Closing debtors (A)	4,150 + 250 – 400	<u>4,000</u>
Cash payments:		
Cash purchases & payment to creditors		
Purchases + Opening creditors – Closing creditors	2,400 + 230 – 250	2,380
Wages and salaries paid	800 + 40 – 50	790
Cash expenses	200 + 10 – 20	190
Taxes paid – Advance tax		<u>195</u>
		<u>3,555</u>
Cash flow from operating activities (A – B)		<u>445</u>

#### By indirect method

Profit before tax	710
<i>Add:</i> Non-cash items : Depreciation	100
<i>Add:</i> Interest : Financing cash outflow	60



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## Company Accounts

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Less: Interest and Dividend : Investment cash inflow		(100)
Less: Tax paid		(195)
Working capital adjustments		
Debtors	250–400	(–150)
Inventories	180–200	(–20)
Creditors	250–230	20
Outstanding wages	50–40	
Outstanding expenses	20–10	<u>(130)</u>
Cash flow from operating activities		<u>445</u>

### Self-examination Questions

#### I. Objective Type Questions

Pick-up the correct answer from the given choices

1. Yash Ltd. wants to prepare its cash flow statement. It sold equipment of book value of Rs. 60,000 at a gain of Rs. 8,000. The amount to be reported in its cash flow statement under operating activities is
  - (a) Nil
  - (b) (8,000)
  - (c) 8,000
2. Cash flows arising from interest paid in the case of a financial enterprise is a cash flow from
  - (a) Financing activity
  - (b) Investing activity
  - (c) Operating activity
3. In the cash flow Statement, 'Cash and Cash equivalents' include
  - (a) Bank and Cash
  - (b) Short-term investments
  - (c) Both (a) and (b)



## Advanced Accounting

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4. As per AS 3 on Cash Flow Statements, cash received by a manufacturing company from sale of shares of ABC Company Ltd. should be classified as
  - (a) Operating activity.
  - (b) Financing activity.
  - (c) Investing activity.
5. While preparing cash flow statement, conversion of debt to equity
  - (a) Should be shown as a financing activity.
  - (b) Should be shown as an investing activity.
  - (c) Should not be shown as it is a non-cash transaction.

[Answer:1(a), 2(c), 3(c), 4(c), 5(c)]

### II. Short Answer Type Questions

6. What additional information can the users obtain from Cash Flow Statements?
7. Discuss briefly the cash flow classification which essential to provide cash flow information to the users of accounts.
8. Give two examples of cash flow from operating and investing activities of a manufacturing concern.

### III. Long Answer Type Questions

9. What is the significance of cash flow statement? Explain various elements of cash and cash equivalents.
10. describe direct and indirect methods of preparing cash flow statements with the help of the example.

### IV. Practical Problems

11. From the following details relating to the Accounts of Grow More Ltd. prepare Cash Flow Statement:

<i>Liabilities</i>	<i>31.03.2006 (Rs.)</i>	<i>31.03.2005 (Rs.)</i>
Share Capital	10,00,000	8,00,000
Reserve	2,00,000	1,50,000
Profit and Loss Account	1,00,000	60,000
Debentures	2,00,000	—
Provision for taxation	1,00,000	70,000



## Company Accounts

Proposed dividend	2,00,000	1,00,000
Sundry Creditors	<u>7,00,000</u>	<u>8,20,000</u>
	<u>25,00,000</u>	<u>20,00,000</u>
Assets		
Plant and Machinery	7,00,000	5,00,000
Land and Building	6,00,000	4,00,000
Investments	1,00,000	–
Sundry Debtors	5,00,000	7,00,000
Stock	4,00,000	2,00,000
Cash on hand/Bank	<u>2,00,000</u>	<u>2,00,000</u>
	<u>25,00,000</u>	<u>20,00,000</u>

(i) Depreciation @ 25% was charged on the opening value of Plant and Machinery.

(ii) During the year one old machine costing 50,000 (WDV 20,000) was sold for Rs. 35,000.

(iii) Rs. 50,000 was paid towards Income tax during the year.

(iv) Building under construction was not subject to any depreciation.

Prepare Cash flow Statement.

12. From the following Balance Sheet and information, prepare Cash Flow Statement of Ryan Ltd. for the year ended 31st March, 2006:

### Balance Sheet

	<i>31st March, 2006</i>	<i>31st March, 2005</i>
	<i>Rs.</i>	<i>Rs.</i>
Liabilities		
Equity Share Capital	6,00,000	5,00,000
10% Redeemable Preference Capital	–	2,00,000
Capital Redemption Reserve	1,00,000	–
Capital Reserve	1,00,000	–
General Reserve	1,00,000	2,50,000
Profit and Loss Account	70,000	50,000



## Advanced Accounting

9% Debentures	2,00,000	–
Sundry Creditors	95,000	80,000
Bills Payable	20,000	30,000
Liabilities for Expenses	30,000	20,000
Provision for Taxation	95,000	60,000
Proposed Dividend	<u>90,000</u>	<u>60,000</u>
	<u>15,00,000</u>	<u>12,50,000</u>
	<i>31st March,</i>	<i>31st March,</i>
	<i>2006</i>	<i>2005</i>
	<i>Rs.</i>	<i>Rs.</i>
Assets		
Land and Building	1,50,000	2,00,000
Plant and Machinery	7,65,000	5,00,000
Investments	50,000	80,000
Inventory	95,000	90,000
Bills Receivable	65,000	70,000
Sundry Debtors	1,75,000	1,30,000
Cash and Bank	65,000	90,000
Preliminary Expenses	10,000	25,000
Voluntary Separation Payments	<u>1,25,000</u>	<u>65,000</u>
	<u>15,00,000</u>	<u>12,50,000</u>

### Additional Information:

- (i) A piece of land has been sold out for Rs. 1,50,000 (Cost – Rs. 1,20,000) and the balance land was revalued. Capital Reserve consisted of profit on sale and profit on revaluation.
- (ii) On 1st April, 2005 a plant was sold for Rs. 90,000 (Original Cost – Rs. 70,000 and W.D.V. – Rs. 50,000) and Debentures worth Rs. 1 lakh was issued at par as part consideration for plant of Rs. 4.5 lakhs acquired.
- (iii) Part of the investments (Cost – Rs. 50,000) was sold for Rs. 70,000.



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## Company Accounts

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- (iv) Pre-acquisition dividend received Rs. 5,000 was adjusted against cost of investment.
- (v) Directors have proposed 15% dividend for the current year.
- (vi) Voluntary separation cost of Rs. 50,000 was adjusted against General Reserve.
- (vii) Income-tax liability for the current year was estimated at Rs. 1,35,000.
- (viii) Depreciation @ 15% has been written off from Plant account but no depreciation has been charged on Land and Building.



**UNIT – 3 : PROFITS OR LOSS PRIOR TO INCORPORATION**

**Learning Objectives**

After studying this unit, you will be able to:

1. Account for pre-incorporation profit.
2. Learn various methods for computing profit or loss prior to incorporation.

**3.1 INTRODUCTION**

When a running business is taken over by the promoters of a company, from a date before the company which is to manage and own is registered, the amount of profit or loss of such a business for the period prior to the date the company came into existence is referred to as pre-incorporation profits or losses. Such profits or losses, though belonging to the company or payable by it, are of capital nature; it is necessary to disclose them separately as trading profits or losses. The general practice in this regard is that if there is a loss, it is either written off by debit to the Profit and Loss Account or to a special account described as "Loss Prior to Incorporation" and show as an "asset" in the Balance Sheet: in the alternative, it is debited to the Goodwill Account. On the other hand, if a profit has been earned by business prior to the same being taken over and the same is not fully absorbed by any interest payable for the period, it is credited to Capital Reserve Account or to the Goodwill Account, if any goodwill has been adjusted as an asset. The profit will not be available for distribution as a dividend among the members of the company.

**3.2 METHODS OF COMPUTING PROFIT OR LOSS PRIOR TO INCORPORATION**

The determination of such profit or loss would be a simple matter if it is possible to close the books and take the stock held by the business before the company came into existence. In such a case, the trial balance will be abstracted from the books and the profit or loss computed: Thereafter, the books will be either closed off or the balance allowed to continue undistributed; only the amount of profit or loss so determined being adjusted in the manner described above. When this is not possible, one or the other of the following methods will have to be followed for the purpose.

- (1) The simplest, though not always the most expedient method is to close off old books and open new books with the assets and liabilities as they existed at the date of incorporation. In this way, automatically the result to that date will be adjusted, the difference between the values of assets and liabilities acquired and the purchase consideration being accounted for either as goodwill or as reserve. The accounts, therefore, would relate exclusively to the post-incorporation period and any adjustment for the pre-incorporation period, whether an adjustment of profit or loss, would not be required.
- (2) Since the decision to take over a business is usually reached long after the date from which it is agreed to be taken over it is normally not possible to follow any of the method



aforementioned. The only alternative left, in the circumstances, is to split up the profit of the year of the transfer of the business to the company between 'pre' and 'post' incorporation periods. This is done either on the time basis or on the turnover basis or by a method which combines the two.

The amount of gross profit of a business is not dependent on time. It is, therefore, more appropriate to distribute it on the basis of turnover. Similarly, the expenses incurred in earning the gross profit, not having any direct relationship thereto, should be distributed on a basis considered appropriate, having regard to the circumstances of each case. Common charges which are fixed *e.g.*, insurance, salaries, depreciation etc., are allocated on time basis, while those which are fluctuating *e.g.*, bad debts, discount and carriage outwards are allocated according to turnover unless, in the light of available information time at which these were incurred or in consideration of the relationship that these bear to the profit of the two periods. For example, interest payable on the credit balance of vendors is charged against the profit of the period before the business was taken over on the consideration that it is in respect of that period before the business was taken over on the consideration that it is in respect of that period that the profit accrued to the company, though the purchase consideration had not been discharged. But if the purchase consideration is not paid on taking over the business, the interest for the subsequent period is charged to the post-incorporation period. Again, preliminary expenses on the formation of the company though incurred in point of time, before the company was incorporated are charged against the profit of the period subsequent to incorporation.

	<i>Rs.</i>
Suppose Sales in Pre-incorporation Period	6,000
Sales in Post-incorporation Period	<u>19,000</u>
	<u>25,000</u>

The company deals in one type of product. The unit cost of sales was reduced by 10% in post incorporation period as compared to the pre-incorporation period in the year. In this case the cost of sales will be divided between the two periods in the ratio of 6,000: 17,100 *i.e.*, 19,000–1,900.

### Illustration 1

Bidyut Limited was incorporated on 1st July, 2005 to acquire from Bijli as and from 1st January, the individual business carried on by him. The purchase price of the fixed assets and goodwill was agreed to be the sum equal to 80% of the profits made each year on ascertainment of the sum due.

The following Trial Balance as on 31st Dec., 2005 is presented to you to enable you to prepare a Balance Sheet as at that date. Also prepare a statement of appropriation of profit writing off one-third of the preliminary expenses.

*Dr.*                      *Cr.*





## Advanced Accounting

	Rs.	Rs.
Share Capital - 1,500 equity shares of Rs. 100 each, Rs. 80 paid up		1,20,000
Sundry Debtors	82,000	
Stock on 31st Dec., 2005	67,000	
Cash at bank and on hand	24,000	
Directors' fee	3,000	
Preliminary expenses	24,000	
Sundry Creditors		32,000
Net Profit for the year after providing for all expenses under agreement entered into with Bijli		<u>48,000</u>
	<u>2,00,000</u>	<u>2,00,000</u>

### Solution

#### Balance Sheet of M/s Bidyut Ltd. as on 31st Dec., 2005

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
<i>Share Capital</i>		<i>Fixed Assets</i>	
Issued & Subscribed Capital 1,500 Equity Shares of Rs. 100 each, Rs. 80 paid up	1,20,000	Goodwill & Fixed Assets	38,400*
<i>Reserves &amp; Surplus</i>		<i>Investments</i>	Nil
Capital Reserve (Pre-incorporation profit)	24,000	<i>Current Assets</i>	
Profit & Loss A/c	13,000	Stock	67,000
Secured Loans	Nil	Debtors	82,000
Unsecured Loans	Nil	Bank	24,000
<i>Current Liabilities &amp; Provisions</i>		<i>Misc. Expenses &amp; Losses not written off</i>	
Trade Creditors	32,000	Preliminary expenses	16,000
Due to Bijli	<u>38,400</u>		
	<u>2,27,400</u>		<u>2,27,400</u>

\*In *Travancore Sugars and Chemicals Ltd. v. CIT* (62 CIT 566), the Supreme Court has held that such payment is a revenue expenditure and deductible from the profits of the company, for tax purposes.



## Company Accounts

### Statement of Appropriation of Profit

	<i>Rs.</i>	<i>Pre-incorporation Rs.</i>	<i>Post-incorporation Rs.</i>
Net Profit for the Year		24,000	24,000
Less: Directors' fee	3,000		
Preliminary Exps.	<u>8,000</u>	<u>        </u>	<u>11,000</u>
		<u>24,000</u>	<u>13,000</u>
Amount Payable to Bijli:			
Profit for the year			48,000
80% due as cost of goodwill, assets, etc.		38,400	

### Illustration 2

Inder and Vishnu, working in partnership registered a joint stock company under the name of Fellow Travellers Ltd. on May 31, 2005 to take over their existing business. It was agreed that they would take over the assets of the partnership for a sum of Rs. 3,00,000 as from January 1st, 2005 and that until the amount was discharged they would pay interest on the amount at the rate of 6% per annum. The amount was paid on June 30, 2005. To discharge the purchase consideration, the company issued 20,000 equity shares of Rs. 10 each at a premium of Re. 1 each and allotted 7% Debentures of the face value of Rs. 1,50,000 to the vendors at par.

The Profit and Loss Account of the "Fellow Travellers Ltd." for the year ended 31st December, 2005 was as follows :

	<i>Rs.</i>		<i>Rs.</i>
Purchase, including stock	1,40,000	Sales:	
Freight and carriage	5,000	1st January to 31st May 2005	60,000
Gross Profit c/d	60,000	1st June to 31st Dec., 2005	1,20,000
	<u>        </u>	Stock in hand	<u>25,000</u>
	<u>2,05,000</u>	Gross profit b/d	<u>2,05,000</u>
Salaries and Wages	10,000		60,000
Debenture Interest	5,250		
Depreciation	1,000		
Interest on Purchase			
Consideration (up to 30-6-2005)	9,000		
Selling Commission	9,000		
Directors' Fees	600		



## Advanced Accounting

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Preliminary Expenses	900	
Provision for taxes	6,000	
Dividend on equity shares @ 5%	5,000	
Balance c/d	<u>13,250</u>	<u>        </u>
	<u>60,000</u>	<u>60,000</u>

Prepare statement apportioning the balance between the 'post' and 'pre-incorporation' periods and also show how these figures would appear in the Balance Sheet of the company.

**Solution:**

### Fellow Travellers Ltd.

#### Statement showing apportionment of profit between periods prior to and since incorporation

	<i>Ratio</i>	<i>Pre- incorporation</i>	<i>Post- incorporation</i>
Gross profit allocated on the basis of sale	1:2	<u>20,000</u>	<u>40,000</u>
Administrative Expenses allocated on time basis:			
(i) Salaries and wages	10,000		
(ii) Depreciation	1,000	4,583	6,417
Selling Commission on the basis of sales	1:2	3,000	6,000
Interest on Purchase Consideration (time basis)	5:1	7,500	1,500
Expenses applicable wholly to the post-incorporation period:			
Debenture Interest	5,250		
Director's Fees	<u>600</u>		
Appropriations:			5,850
Preliminary Exps., w/o	900		
Provision for Tax	6,000		
Dividend on equity share	<u>5,000</u>		11,900
Balance c/d to Balance Sheet		<u>4,917</u>	<u>8,333</u>
		<u>20,000</u>	<u>40,000</u>

Fellow Travellers Ltd.



## Company Accounts

### Extract From the Balance Sheet as on 31st Dec., 2005

Share Capital:	<i>Rs.</i>
20,000 equity shares of Rs. 10 each fully paid	2,00,000
Reserve and Surplus:	
Profit Prior to Incorporation	4,917
Securities Premium Account	20,000
Profit and Loss Account	8,333
7% Debentures	1,50,000
Provision for Taxes	<u>6,000</u>
Total	<u>3,89,250</u>

### Illustration 3

The partners of Maitri Agencies decided to convert the partnership into a private limited company called MA (P) Ltd. with effect from 1st January, 2005. The consideration was agreed at Rs. 1,17,00,000 based on the firm's Balance Sheet as at 31st December, 2004. However, due to some procedural difficulties, the company could be incorporated only on 1st April, 2005. Meanwhile the business was continued on behalf of the company and the consideration was settled on that day with interest at 12% per annum. The same books of account were continued by the company which closed its account for the first time on 31st March, 2006 and prepared the following summarized profit and loss account.

	<i>Rs.</i>
Sales	2,34,00,000
<i>Cost of goods sold:</i>	1,63,80,000
Salaries	11,70,000
Depreciation	1,80,000
Advertisement	7,02,000
Discounts	11,70,000
Managing Director's remuneration	90,000
Miscellaneous office expenses	1,20,000
Office-cum-show room rent	7,20,000
Interest	<u>9,51,000</u>
Profit	<u>2,14,83,000</u> <u>19,17,000</u>

The company's only borrowing was a loan of Rs. 50,00,000 at 12% p.a. to pay the purchase consideration due to the firm and for working capital requirements.



## Advanced Accounting

The company was able to double the average monthly sales of the firm, from 1st April, 2005 but the salaries trebled from that date. It had to occupy additional space from 1st July, 2005 for which rent was Rs. 30,000 per month.

Prepare a profit and loss account in a columnar form apportioning cost and revenue between pre-incorporation and post-incorporation periods. Also, suggest how the pre-incorporation profits are to be dealt with.

### Solution

### MA (P.) Ltd.

#### Profit & Loss A/c for 15 months ended 31st March, 2005

	<i>Pre-inc.</i>	<i>Post-inc.</i>		<i>Pre-inc.</i>	<i>Post-inc.</i>
	<i>Rs.</i>	<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
To Cost of goods sold	18,20,000	1,45,60,000	By Sales	26,00,000	2,08,00,000
" Salaries	90,000	10,80,000	" Loss	19,000	
" Depreciation	36,000	1,44,000			
" Advertisement	78,000	6,24,000			
" Discounts	1,30,000	10,40,000			
" M.D.'s remuneration	—	90,000			
" Misc. Office Expenses	24,000	96,000			
" Rent	90,000	6,30,000			
" Interest	3,51,000	6,00,000			
" Net Profit	—	<u>19,36,000</u>			
	<u>26,19,000</u>	<u>2,08,00,000</u>		<u>26,19,000</u>	<u>2,08,00,000</u>

### Working Notes:

- (1) Calculation of ratio of sales:

Let the average sales per month in pre-incorporation period be  $x$ . Then the average sales in post-inc. period are  $2x$ . Thus total sales are  $(3 \times x) + (12 \times 2x)$  or  $27x$ . Ratio of sales will be  $3x : 24x$  or  $1:8$ .

Time ratio is 3 months : 12 months or  $1:4$

- (2) Expenses apportioned on turnover ratio basis are cost of goods sold, advertisement, discounts.  
(3) Expenses apportioned on time ratio basis are Depreciation, and misc. office expenses.  
(4) Ratio for apportionment of Salaries:

If pre-incorporation monthly average is  $x$ , for 3 months  $3x$ .

Average for balance 12 months  $3x$ , for 12 months  $36x$ .



## Company Accounts

Hence ratio for division, 1:12.

(5) Apportionment of Rent:

	<i>Rs.</i>
Total Rent	7,20,000
Additional rent for 9 months (From 1st July to 31st March, 2005)	<u>2,70,000</u>
Rent for old premises for 15 months or Rs. 30,000 p.m.	<u>4,50,000</u>

	Pre-inc.	Post-inc.
Old Premises	90,000	3,60,000
Addl.:"	=	<u>2,70,000</u>
	<u>90,000</u>	<u>6,30,000</u>

### Note on treatment

Since the profits prior to incorporation are in the negative, they would:

- (a) either be considered as a reduction from any capital reserve accruing in relation to the transaction, or
- (b) be treated as goodwill.

### Illustration 4

ABC Ltd. was incorporated on 1.5.2006 to take over the business of DEF and Co. from 1.1.2006. The Profit and Loss Account as given by ABC Ltd. for the year ending 31.12.2005 is as under:

#### Profit and Loss Account

	<i>Rs.</i>		<i>Rs.</i>
To Rent and Taxes	90,000	By Gross Profit	10,64,000
To Salaries including manager's salary of Rs. 85,000	3,31,000	By Interest on Investments	36,000
To Carriage Outwards	14,000		
To Printing and Stationery	18,000		
To Interest on Debentures	25,000		
To Sales Commission	30,800		
To Bad Debts (related to sales)	91,000		
To Underwriting Commission	26,000		
To Preliminary Expenses	28,000		



## Advanced Accounting

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To	Audit Fees	45,000	
To	Loss on Sale of Investments	11,200	
To	Net Profit	<u>3,90,000</u>	
		<u>11,00,000</u>	<u>11,00,000</u>

Prepare a Statement showing allocation of pre-incorporation and post-incorporation profits after considering the following informations:

- (i) G.P. ratio was constant throughout the year.
- (ii) Sales for January and October were 1½ times the average monthly sales while sales for December were twice the average monthly sales.
- (iii) Bad Debts are shown after adjusting a recovery of Rs. 7,000 of Bad Debt for a sale made in July, 2003.
- (iv) Manager's salary was increased by Rs. 2,000 p.m. from 1.5.2006.
- (v) All investments were sold in April, 2006.

### Solution

Pre-incorporation period is for four months, from 1st January, 2006 to 30th April, 2006. 8 months' period (from 1st May, 2006 to 31st December, 2006) is post-incorporation period.

### Profit and Loss Account for the year ended 31st December, 2006

		<u>Pre-Inc</u>	<u>Post -Inc</u>				<u>Pre-Inc</u>	<u>Post inc</u>	
		<i>Rs.</i>	<i>Rs.</i>				<i>Rs.</i>	<i>Rs.</i>	
To	Rent and Taxes	30,000	60,000	By	Gross Profit	3,42,000	7,22,000		
To	Salaries			By	Interest on Investments	36,000	-		
	Manager's Salary	23,000	62,000		Bad Debts	7,000	-		
	Other Salaries	82,000	1,64,000	By	Recovery				
To	Printing and Stationery	6,000	12,000						
To	Audit fees	15,000	30,000						
To	Carriage Outwards	4,500	9,500						
To	Sales Commission	9,900	20,900						
To	Bad Debts (91,000 + 7,000)	31,500	66,500						
To	Interest on Debentures	-	25,000						



## Company Accounts

To	Underwriting Commission	–	26,000		
To	Preliminary Expenses	–	28,000		
To	Loss on sale of investments	11,200	–		
To	Net Profit	<u>1,71,900*</u>	<u>2,18,100</u>		
		<u>3,85,000</u>	<u>7,22,000</u>	<u>3,85,000</u>	<u>7,22,000</u>

\*Pre-incorporation profit is a capital profit and will be transferred to Capital Reserve.

### Working Notes

- (i) Calculation of ratio of Sales  
Let average monthly sales be  $x$ .  
Thus Sales from January to April are  $4\frac{1}{2}x$  and sales from May to December are  $9\frac{1}{2}x$ .  
Sales are in the ratio of  $9/2x : 19/2x$  or  $9 : 19$ .
- (ii) Gross profit, carriage outwards, sales commission and bad debts written off have been allocated in pre and post incorporation periods in the ratio of Sales i.e.  $9 : 19$ .
- (iii) Rent, salaries, printing and stationery, audit fees are allocated on time basis.
- (iv) Interest on debentures, underwriting commission and preliminary expenses are allocated in post incorporation period.
- (v) Interest on investments, loss on sale of investments and bad debt recovery are allocated in pre-incorporation period.

### Self Examination Questions

#### I Objective type questions

Choose the most appropriate answer from the questions:

1. Profit prior to incorporation is transferred to
  - (a) General reserve.
  - (b) Capital reserve.
  - (c) Profit and loss account.
  - (d) None of the above.
  
2. The profit earned by the company from the date of purchase to the date of incorporation is
  - (a) Pre- incorporation profit.





## Advanced Accounting

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- (b) Post- incorporation profit.
- (c) Notional profit.
- (d) Estimated profit.

### II Short answer type questions

3. Write a short note on Profit or loss prior to pre-incorporation.

### III Long answer type questions

4. Explain various methods of computing profit or loss prior to pre-incorporation in detail.

### IV Practical problems

5. Flat Private Ltd. Was incorporated on 1<sup>st</sup> July, 2005 to take over the running business of Mr. Round with effect from 1<sup>st</sup> April, 2005. The following Profit and Loss Account for the year ended 31<sup>st</sup> March, 2006 was drawn up:

To	Commission	Rs. 2,625	By	Gross Profit	Rs. 98,000
"	Advertisement	5,250	"	Bad Debt Realised	500
"	Managing director's Remuneration	9,000			
"	Depreciation	2,800			
"	Salaries	18,000			
"	Insurance	600			
"	Preliminary Expenses	700			
"	Rent & Taxes	3,000			
"	Discount	350			
"	Bad Debts	1,250			
"	Net Profit	54,925			
		98,500			98,500

The following details are available:

- (i) The average monthly turnover from July 2005 onwards was double than that of the previous months.



## Company Accounts

(ii) Rent for the first 3 months was paid @ Rs.200 p.m. and thereafter at a rate increased by Rs.50 p.m.

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

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

6. B. Ltd. Was incorporated on 30<sup>th</sup> June, 2005 to take over the business of T. Ltd. As from 1<sup>st</sup> January, 2005. The financial accounts of the business for the year ended 31<sup>st</sup> December, 2005 disclosed the following information:

		Rs.	Rs.
Sales -	January to June	1,20,000	
	July to December	1,80,000	
			3,00,000
Less:	Purchases - January to June	75,000	
	- July to December	1,20,000	
	Gross Profit		1,05,000
Less:	Salaries	15,000	
	Selling Expenses	3,000	
	Depreciation	1,500	
	Director's Remuneration	750	
	Debenture Interest	90	
	Administration Expenses (Rent, Rates etc.)	4,500	
			<u>24,840</u>
			<u>80,160</u>

You are required to prepare a statement apportioning the balance of profit between the periods prior to and since incorporation and show the profit and loss appropriation account for the year ended 31<sup>st</sup> December, 2005



UNIT – 4

Learning Objectives

After studying this unit, you will be able to

1. Sub-divide and consolidate shares.
2. Convert shares into stock and stock into shares.
3. Apply SEBI guidelines regarding rights issue and also for issue of bonus shares.
4. Understand the provisions relating to buy-back of securities.
5. Account for Employees Stock Option Scheme.

4.1 ALTERATION OF SHARE CAPITAL

*Sub-division and Consolidation of Shares:* If authorised by its Articles, a company may, in a general meeting, decide to sub-divide or consolidate the shares into those of a smaller or higher denomination than that fixed by the Memorandum of Association, so long as the proportion between the paid up and unpaid amount, if any, on the shares continues to be the same as it was in the case of the original shares.

For example, a company with a capital of Rs. 10,00,000 divided into 10,000 equity shares of Rs. 100 each on which Rs. 75 is paid up decides to recognise its capital by splitting one equity share of Rs. 100 each into 10 such shares of Rs. 10 each. The consequential entry to be passed in such a case would be—

		Dr.	Cr.
		Rs.	Rs.
Equity Share Capital (Rs. 100) A/c	Dr.	7,50,000	
To Equity Share Capital (Rs. 10) A/c			7,50,000

(Being the sub-division of 10,000 shares of Rs. 100 each with Rs. 75 paid up thereon into 1,00,000 shares of Rs. 10 each with Rs. 7.50 paid up thereon as per the resolution of shareholders passed in the General Meeting held on...)

Similar entries will be passed on consolidation of shares of a smaller amount into those of a larger amount as well as on converting fully paid shares into stock.

Illustration 1

On 31-12-2004 B Ltd. had 20,000, Rs. 10 Equity Shares as authorised capital and the shares were all issued on which Rs. 8 was paid up. In June, 2005 the company in general meeting decided to *sub-divide* each share into two shares of Rs. 5 with Rs. 4 paid up. In June, 2006



## Company Accounts

the company in general meeting resolved to *consolidate* 20 shares of Rs. 5, Rs. 4 per share paid up into one share of Rs. 100 each, Rs. 80 paid up.

Pass entries and show how share capital will appear in the Balance Sheet as on 31-12-2004, 31-12-2005 and 31-12-2006.

### Solution

#### Journal entries

		Rs.	Rs.
2005			
June	Equity Share Capital (Rs. 10) A/c	Dr.	1,60,000
	To Equity Share Capital (Rs. 5) A/c		1,60,000
(Being the sub-division of 20,000 Rs. 10 shares with Rs. 8 paid up into 40,000 shares Rs. 5 each with Rs. 4 paid up by resolution in general meeting dated....)			
<hr/>			
2006			
June	Equity Share Capital (Rs. 5) A/c	Dr.	1,60,000
	To Equity Share Capital (Rs. 100) A/c		1,60,000
(Being consolidation of 40,000 shares of Rs. 5 with Rs. 4 paid up into 2,000 Rs. 100 shares with Rs. 80 paid up as per resolution in general meeting dated....)			
<hr/>			

#### Balance Sheet (*includes*)

	Rs.
<i>Liabilities :</i>	
<i>As on 31-12-2004</i>	
<b>1. Share Capital</b>	
<i>Authorised :</i>	
20,000 Equity Shares of Rs. 10 each	<u>2,00,000</u>
<i>Issued and Subscribed :</i>	
20,000 Equity Shares of Rs. 10 each Rs. 8 per share called up	1,60,000
<i>As on 31-12-2005</i>	
<b>1. Share Capital</b>	
<i>Authorised :</i>	
40,000 Equity Shares of Rs. 5 each	2,00,000
<i>Issued and Subscribed :</i>	
40,000 Equity Shares of Rs. 5 each Rs. 4 per share called up	1,60,000



## Advanced Accounting

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As on 31-12-2006

Rs.

### 1. Share Capital

*Authorised :*

2,000 Equity Shares of Rs. 100 each 2,00,000

*Issued and Subscribed :*

20,000 Equity Shares of Rs. 100 each Rs. 80 per share called up 1,60,000

**Note:** Some accountants prefer not to make any entry as the amount remains same. Even when an entry is passed it applies only to the called up portion, and not to uncalled or unissued portion of share capital.

### 4.2 CONVERSION OF FULLY PAID SHARES INTO STOCK AND STOCK INTO SHARES

Stock is the consolidation of the share capital into one unit divisible into aliquot parts. While it is impossible of the share capital to be one share, any amount of stock may be transferred. In practice, however, companies restrict the transfer of stock to multiples of, say, Rs. 100. A company can convert its fully paid shares into stock [Section 94(c)]. Upon the company converting its shares into stock, the book-keeping entries merely record the transfer from share capital account to stock account. But a separate Stock Register is started in which details of members' holdings are entered and the annual return is modified accordingly.

#### Illustration 2

C Ltd. had Rs. 5,00,000 authorised capital on 31-12-2004 divided into shares of Rs. 100 each out of which 4,000 shares were issued and fully paid up. In June 2005 the Company decided to *convert* the issued shares into stock. But in June, 2006 the Company *re-converted* the stock into shares of Rs. 10 each fully paid up.

Pass entries and show how Share Capital will appear in Balance Sheet as on 31-12-2004, 31-12-2005 and 31-12-2006.

#### Solution

#### Journal Entries

2005			Rs.	Rs.
June	Equity Share Capital A/c	Dr.	4,00,000	
	To Equity Stock A/c			4,00,000
	(Being conversion of 4,000 fully paid Equity Shares of Rs. 100 into Rs. 4,00,000 Equity Stock as per resolution in general meeting dated...)			

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## Company Accounts

2006				
June	Equity Stock A/c	Dr.	4,00,000	
	To Equity Share Capital A/c			4,00,000
	(Being re-conversion of Rs. 4,00,000 Equity Stock into 40,000 shares of Rs. 10 fully paid Equity Shares as per resolution in General Meeting dated...)			

### Balance Sheet (includes)

#### Liabilities :

As on 31-12-2004

Rs.

#### 1. Share Capital

Authorised

5,000 Equity Shares of Rs. 100 each

5,00,000

Issued and Subscribed

4,000 Equity Shares of Rs. 100 each fully called up

4,00,000

As on 31-12-2005

Rs.

#### 1. Share Capital

Authorised

5,000 Equity Shares of Rs. 100 each

5,00,000

Issued and Subscribed

Equity Stock-4,000 Equity Shares of Rs. 100 converted into Stock

4,00,000

As on 31-12-2006

Rs.

#### 1. Share Capital

Authorised

50,000 Equity Shares of Rs. 10 each

5,00,000

Issued and Subscribed

40,000 Equity Shares of Rs. 10 each fully called up

4,00,000

### 4.3 PREFERENTIAL ALLOTMENT

There are three methods of expanding the share capital by an existing company. The first one is through a fresh issue of shares to existing shareholders in proportion to the shares held by them (rights or bonus issues). Second is by making an offer, inviting the public in general to subscribe shares, which is generally known as Initial Public Offer (IPO). The third method is by making a bulk allotment to an individual, companies, venture capitalists or any other person



through a fresh issue of shares. It is known as preferential allotment. Preferential allotment in the form of bulk allotment need not be discussed here in detail.

**4.3.1 Rights shares:** A right issue is a cheap way of raising finance. It is an issue of shares in which the existing shareholders have a pre-emptive right to subscribe for the new shares. In a rights issue, no prospectus is issued or offer for sale of shares is made; instead, existing equity shareholders are given 'rights certificates' in proportion to the existing holding which entails them to take up a specified number of shares at a specified price. The price of the shares so offered is usually below listed price to make the offer attractive. The reason for fixing the rights price at a discount to the current market price is that shareholders need encouragement to subscribe for extra shares. If a company wishes to raise more money, then it can attempt to issue a greater number of shares through the rights issue. An existing shareholder who does not wish to exercise any or all of the rights is at liberty to sell them to third parties who can purchase such shares at a specified price. Alternatively, shareholders may renounce their rights in favour of the company which may sell the shares to the public in such a manner as the Board of Directors think most beneficial to the company.

It should be noted that there are two main reasons for a company to come out with a rights issue. A rights issue may be the only way of raising finance when the company is in need of cash to carry out existing operations. Share prices of the company are likely to fall since the same amount of profit will be distributed to more number of shareholders. If the company needs the finance for profitable investment and issue of rights share is the answer to the external financial requirement, then the share price is likely to rise. On the other hand, if it appears that the expansion will generate the same rate of return as existing operations, the market price of the shares will be unaffected. The existing shareholders will be neither better nor worse off, since the value of the company remains unchanged.

The accounting entries in the books of the company for a rights issue are the same as those required for a new issue of shares to the public. There is only one exception – the existing shareholders know in advance the number of shares to which they will be entitled. Therefore, no question of over or under subscription arises.

### Illustration 3

A Ltd. has an issued capital of 20,000 equity shares of Rs.10 each fully called-up.

The following decisions are taken by the company:

- (a) To forfeit 100 shares on which only Rs.5 per share has been paid-up and to re-issue them at Rs.15 per share as fully paid-up.
- (b) To issue 'Right Shares' in the ratio of 1 fully paid-up share for every 4 existing shares held, at Rs.15 per share. Assuming that the company has sufficient general reserve, record the above through Journal entries.



Solution

In the books of A Ltd.

Journal		Dr.	Cr.
Date	Particulars	Rs.	Rs.
(a)	Equity Share Capital A/c (100 x 10)	Dr. 1,000	
	To Calls-in-Arrear A/c		500
	To Forfeited Shares A/c		500
	(Being forfeiture of 100 shares for non-payment of call money as per Boards' Resolution No....dated...)		
	Bank A/c	Dr. 1,500	
	To Equity Shares Capital A/c		1,000
	To Securities Premium A/c		500
	(Being re-issue of 100 shares of Rs.10 each as fully paid-up at a premium of Rs.5 per share as per Boards' Resolution No....dated...)		
	Forfeited Shares A/c	Dr. 500	
	To Capital Reserve A/c		500
	(Being the profit on re-issue transferred to Capital Reserve Account)		
(b)	Bank A/c	Dr. 75,000	
	To Equity Share Application A/c		75,000
	(Being application money received for 5,000 rights shares @ Rs.15 each)		
	Equity Share Application A/c	Dr. 75,000	
	To Equity Share Capital A/c		50,000
	To Securities Premium A/c		25,000
	(Being issue of 1 Rights Share for 4 shares held @ Rs.15 each, as per Board's Resolution No...dated...)		

**4.3.2 Bonus Shares :**The Companies Act does not contain any specific provision regarding capitalisation of profits and consequently issue of bonus shares. However, the Companies Act permits that the share premium amount can be used by the company in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. Also the company can utilise the amount of the capital redemption reserve in paying up unissued shares of the company to be issued to its members as fully paid bonus shares. The SEBI (Disclosure and Investor





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Protection) Guidelines, 2000 which came into force w.e.f. 27th day of January, 2000 require that the company while issuing bonus shares shall ensure the following :

- (a) No company shall, pending conversion of FCDs/PCDs/ issue any by way of bonus unless similar benefit is extended to the holders of such FCDs/ through reservation of shares in proportion to such convertible part of FCDs or PCDs
- (b) The shares so reserved may be issued at the time of conversion(s) debentures on the same terms on which the bonus issues were made.

The bonus issue shall be made out of free reserves built of the profits or share premium collected in cash only.

Reserves created by revaluation of fixed assets are not capitalised.

The declaration of bonus issue, in lieu of dividend, is not made.

The bonus issue is not made unless the partly-paid shares, if any, are made fully paid-up.

The company—

- (a) has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption and
- (b) has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus etc.

A company which announces its bonus issue after the approval of the Board of directors must implement the proposal within a period of six months from the date of such approval and shall not have the option of changing the decision.

- (i) The articles of association of the company shall contain a provision for capitalisation of reserves; etc.
- (ii) If there is no such provision in the articles the company shall pass a resolution at its general body meeting making provisions in the articles of association for capitalisation.

Consequent to the issue of bonus shares, if the subscribed and paid up capital exceed the authorised share capital a resolution shall be passed by the company at its general body meeting for increasing the authorised capital.

### Journal Entries :

- (1) Upon the sanction of an issue of bonus shares —

Debit Profit & Loss Account (or reserve)

Credit Bonus to Shareholders Account.



## Company Accounts

(2) Upon issue of share —

Debit Bonus to Shareholders Account

Credit Share Capital Account.

If partly paid shares are to be made fully paid by way of bonus, entry No. (2) will be split into two entries :

(a) Debit Call Account and Credit Share Capital Account, and

(b) Debit Bonus to Shareholders Account and Credit Call Account.

### Illustration 4

Following is the extract of the Balance Sheet of Solid Ltd. as at 31st March, 2006:

	<i>Rs.</i>
Authorised capital :	
10,000            12% Preference shares of Rs. 10 each	1,00,000
1,00,000            Equity shares of Rs. 10 each	<u>10,00,000</u>
	<u>11,00,000</u>
Issued and Subscribed capital:	
8,000            12% Preference shares of Rs. 10 each fully paid	80,000
90,000    Equity shares of Rs. 10 each, Rs. 8 paid up	7,20,000
Reserves and Surplus :	
General reserve	1,20,000
Capital reserve	75,000
Securities premium	25,000
Profit and Loss Account	2,00,000
Secured Loan :	
12% Partly Convertible Debentures @ Rs. 100 each	<u>5,00,000</u>

On 1st April, 2006 the Company has made final call @ Rs. 2 each on 90,000 equity shares. The call money was received by 20th April, 2006. Thereafter the company decided to capitalise its reserves by way of bonus at the rate of one share for every four shares held. Share premium of Rs. 25,000 includes a premium of Rs. 5,000 for shares issued to vendors pursuant to a scheme of amalgamation. Capital reserves include Rs. 40,000, being profit on sale of plant and machinery. 20% of 12% debentures are convertible into equity shares of Rs. 10 each fully paid on 1st July, 2006.



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Show necessary entries in the books of the company and prepare the extract of the Balance Sheet immediately after bonus issue but before conversion of debentures. Are the convertible debentureholders entitled to bonus shares ?

### Solution

#### Solid Ltd. Journal Entries

		<i>Dr.</i>	<i>Cr.</i>
		<i>Rs.</i>	<i>Rs.</i>
2006			
April 1	Equity Share Final Call A/c	Dr. 1,80,000	
	To Equity Share Capital A/c		1,80,000
	<i>(Final call of Rs. 2 per share on 90,000 equity shares due as per Board's Resolution dated....)</i>		
April 20	Bank A/c	Dr. 1,80,000	
	To Equity Share Final Call A/c		1,80,000
	<i>(Final Call money on 90,000 equity shares received)</i>		
	Capital Reserve A/c1	Dr. 40,000	
	Securities Premium A/c2	Dr. 20,000	
	General Reserve A/c	Dr. 1,20,000	
	Profit and Loss A/c	Dr. 45,000	
	To Bonus to Shareholders A/c		2,25,000
	<i>(Bonus issue @ one share for every four shares held by utilising various reserves as per Board's Resolution dated...)</i>		
April 20	Bonus to Shareholders A/c	Dr. 2,25,000	
	To Equity Share Capital A/c		2,25,000
	<i>(Capitalisation of profit)</i>		

#### Balance Sheet (Extract) As on 30th April, 2006 (after bonus issue)

	<i>Rs.</i>
Authorised Capital :	
10,000                      12% Preference shares of Rs. 10 each	1,00,000
1,25,000                    Equity shares of Rs. 10 each	<u>12,50,000</u>
Issued and Subscribed Capital :	
8,000              12% Preference shares of Rs. 10 each, fully paid	80,000



## Company Accounts

1,12,500	Equity shares of Rs. 10 each, fully paid	11,25,000
	(Out of above, 22,500 equity shares @ Rs. 10 each were issued by way of bonus)	
Reserves and Surplus :		
	Capital Reserve	35,000
	Securities premium	5,000
	Profit and Loss Account	1,55,000
Secured Loan :		
	12% Convertible Debentures @ Rs. 100 each	<u>5,00,000</u>

### Notes

1. Capital reserve realised in cash can be utilised for issue of fully paid bonus shares.
2. As per SEBI guidelines, share premium collected in cash can only be utilised for bonus issue.
3. It is assumed that the company will pass necessary resolution at its general body meeting for increasing the authorised capital. In anticipation, the authorised capital has been suitably increased as below :

Existing number of equity shares as authorised	1,00,000*
<i>Add</i> : Issue of bonus shares to equity shareholders	22,500
<i>Add</i> : Number of bonus shares to be issued to debentureholders after conversion	<u>2,500</u>
	<u>1,25,000</u>

\*This figure covers the number of shares required for conversion of debentures.

4. As per para (i) of SEBI guidelines, no company can issue bonus shares to its shareholders without extending similar bene-fit to convertible debenture holders. Pending such conversion, necessary number of shares should be earmarked for convertible debenture holders. Therefore, convertible debenture holders are also entitled to the bonus shares in the same ratio as the equity shareholders.

### 4.4 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.

#### **4.5 EMPLOYEES STOCK OPTION**

The Companies (Amendment) Act 2000 has inserted a new clause (15 A) 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 fo 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.

##### **4.5.1 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 :-

**Illustration 5**

A Company has its share capital divided into shares of Rs. 10 each. On 1st April, 2005 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, 2005 and 15th March, 2006. 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. Rs.	Cr. Rs.
2005			
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)		
2006			
16th Dec.	Bank	Dr. 3,80,000	



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to 15th  
March

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. Deferred Employee Compensation will appear in the Balance Sheet as a negative item as part of Net Worth or Shareholders' Equity.

### 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) Identified 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.

#### 4.6 BUYBACK 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.





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*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.

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.

### Self-examination questions

#### I Objective type questions

Pick-up the correct answers from the given options

Use the following information for questions 1 to 5



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The Authorized Share Capital of A Ltd. is Rs.20,00,000 of Rs.100 each issued at a premium of 50%. The Issued/Called up and Paid-up Equity Share Capital of the company is Rs.10,00,000. The company announced a Rights issue of four shares of Rs.100 each at a premium of 160% for every five shares held by the existing shareholders. The market value of the share at the time of rights issue is Rs.440. All the rights have been subscribed and paid -up by the existing shareholders.

1. The balance in Equity Share Capital A/c after the right issue is \_\_\_\_\_.  
(a) Rs 18,00,000 (b) Rs 22,50,000 (c) Rs 8,00,000 (d) Rs 12,50,000
2. The balance in Securities Premium A/c after the right issue is \_\_\_\_\_.  
(a) Rs 5,00,000 (b) Rs 12,80,000 (c) Rs 7,80,000 (d) Rs 17,80,000
3. The cum-right value of a share is \_\_\_\_\_.  
(a) Rs 28 (b) Rs 56 (c) Rs 412 (d) Rs 440
4. The ex-right value of a share is \_\_\_\_\_.  
(a) Rs 28 (b) Rs 56 (c) Rs 384 (d) Rs 412
5. The value of a right is \_\_\_\_\_.  
(a) Rs 28 (b) Rs 56 (c) Rs 384 (d) Rs 412
6. R Ltd. has accumulated large profits in the Reserve Account and the directors decide to capitalize part of the reserves by converting partly paid shares into fully paid up shares and issuing Bonus shares.

The paid up share capital of the company is Rs.10,00,000 consisting of 90,000 Class A Equity shares of Rs.10 each fully paid and 20,000 Class B Equity shares (face value Rs.10 each) Rs.5 per share paid up. The directors decide to issue two bonus shares at par of Rs.10 for every fully paid share held and to make the partly paid shares fully paid in respect of Class B Equity shares. At the date of the allotment of bonus shares the market value of the Class B Equity Share stands at Rs.33.

The amount of reserves to be capitalized = ?

- (a) Rs.2,00,000 (b)Rs.3,00,000 (c) Rs.4,00,000 (d) Rs.5,00,000
7. Which of the following statements is **false** with regard to Rights Issue?
  - (a) Rights issue is made to the existing shareholders
  - (b) In Rights issue too there is a chance of over-subscription and pro-rata allotment of shares



- (c) The price of a Rights share is much less than the existing market price per share
- (d) The flotation cost of Rights issue is low
- 8. Which of the following statements is **true** with regard to declaring and issuing of Bonus Shares?
  - (a) Assets are transferred from the company to the share holders
  - (b) A Bonus issue results in decrease in retained earnings
  - (c) Share holders' equity is reduced
  - (d) A Bonus issue is same as declaration of dividends

[Answer: 1 (a), 2 (d), 3 (e), 4(c), 5 (b), 6 (d), 7 (b),8 (b)]

**II Short answer type questions**

- 9. Can a company issue equity share with differential rights? Explain provisions for such issue in brief..
- 10. What is meant by "buy back of securities"? Explain in brief.
- 11. Write a short note on " preferential allotment".
- 12. Define the term ' Consolidation of shares'.

**III Long answer type questions**

- 13. Discuss SEBI provisions regarding issue of bonus shares.
- 14. Describe the accounting treatment of shares issued under employees stock option scheme.

**IV Practical problems**

- 15. **The Balance Sheet of A Ltd. as at 31-3-2006 is as follows:**

<i>Liabilities</i>	<i>Amount</i>	<i>Assets</i>	<i>Amount</i>
Authorised share capital:		Sundry Assets	17,00,000
1,50,000 equity shares of Rs.10 each	<u>15,00,000</u>		
Issued, subscribed and paid up capital:			
80,000 equity shares Rs.7.50 called up and paid up	6,00,000		
Capital Redemption Reserve	1,50,000		



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Plant Revaluation Reserve	20,000	
Securities Premium	1,50,000	
Development Rebate Reserve	2,30,000	
Investment Allowance Reserve	2,50,000	
General Reserve	3,00,000	
	17,00,000	17,00,000

The company wanted to issue bonus shares to its shareholders on one-for-two basis. Necessary resolutions were passed and requisite legal requirements were complied with.

You are required to give effect to the proposal by passing journal entries in the books of A Ltd. Also show the Balance sheet after issue of bonus shares.

### **APPENDIX**

The SEBI (Disclosure and Investor Protection) Guidelines, 2000 which came into force w.e.f. 27th day of January, 2000 relating to issue of shares are as follows:

#### **1. Public issue by unlisted companies**

1.1 An unlisted company shall make a public issue of any equity shares or any security convertible into equity shares at a later date subject to the following:

- (i) It has a pre-issue networth of not less than Rs. 1 crore in three (3) out of preceding five (5) years, with a minimum networth to be met during immediately preceding two (2) years; and
- (ii) It has a track record of distributable profits in terms of Section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years:

Provided that the issue size (i.e. offer through offer document + firm allotment + promoters' contribution through the offer document) does not exceed five (5) times its pre-issue networth as per the last available audited accounts, either at the time of filing draft offer document with the Board or at the time of opening of the issue.

1.2 An unlisted company can make a public issue of equity shares or any security convertible into equity shares at a later date, only through the book-building process if, -

- (i) it does not comply with the conditions specified in clause 1.1 above, or



- (ii) its proposed issue size exceeds five times its pre-issue networth as per the last available audited accounts either at the time of filing draft offer document with the Board or at the time of opening of the issue:

Provided that sixty per cent (60%) of the issue size shall be allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded.

## **2. Public issue by listed companies**

- 2.1 A listed company shall be eligible to make a public issue of equity shares or any security convertible at later date into equity share:

Provided that the issue size (i.e. offer through offer document firm allotment + promoters' contribution through the offer document) does not exceed five (5) times its pre-issue networth as per the last available audited accounts either at the time of filing draft offer document with the Board or at the time of opening of the issue.

- 2.2 A listed company which does not fulfil the condition given in the proviso to clause 2.1 above, shall be eligible to make a public issue only through the book building process:

Provided that sixty per cent (60%) of the issue size shall be allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies shall be refunded.

- 2.3 A listed company which has changed its name so as to indicate that it is a company in the information technology sector as defined in clause (iii) of Explanation 2 of clause 1.1, during a period of three years prior to filing of offer document with the Board, shall comply with the requirements of clause 1 for unlisted companies, before it can make a public issue of equity shares or securities convertible at a later date into equity shares.

## **3. Pricing by companies issuing securities**

The companies eligible to make public issue can freely price their equity shares or any security convertible at later date into equity shares in the following cases:

- 3.1 **Public/right issue by listed companies :** A listed company whose equity shares are listed on a stock exchange, may freely price its equity shares and any security convertible into equity at a later date, offered through a public or rights issue.

- 3.2 **Public issue by unlisted companies:**

- 3.2.1 An unlisted company eligible to make a public issue and desirous of getting its securities listed on a recognised stock exchange pursuant to a public issue, may freely price its equity shares or any securities convertible at a later date into equity shares.

- 3.2.2 *Infrastructure company.* An eligible infrastructure company shall be free to price its equity shares subject to the compliance with the disclosure norms as specified by SEBI from time to time.



### **3.3 Initial public issue by banks**

The banks (whether public sector or private sector) may freely price their issue of equity shares or any securities convertible at a later date into equity share subject to approval by the Reserve Bank of India.

### **3.4 Differential pricing**

**3.4.1** Any unlisted company or a listed company making a public issue of equity shares or securities convertible at a later date into equity shares, may issue such securities to applicants in the firm allotment category at a price different from the price at which the net offer to the public is made provided that the price at which the security is being offered to the applicants in firm allotment category is higher than the price at which securities are offered to public.

Explanation : The net offer to the public means the offer made to the Indian public and does not include firm allotments or reservations or promoters' contributions.

**3.4.2** A listed company making a composite issue of capital may issue securities at differential prices in its public and rights issue.

**3.4.3** In the public issue which is part of a composite issue, differential pricing as per sub-clause 3.4.1 above is also permissible.

**3.4.4** Justification for the price difference shall be given in the offer document (or sub-clauses 3.4.1 and 3.4.2.).

### **3.5 Price band**

**3.5.1** Issuer company can mention a price band of 20% (cap in the price band should not be more than 20% of the floor price) in the offer documents filed with the Board and actual price can be determined at a later date before filing of the offer document with ROCs.

**3.5.2** If the Board of directors has been authorised to determine the offer price within a specified price band, such price shall be determined by a resolution to be passed by the Board of directors.

**3.5.3** The lead merchant bankers shall ensure that in case of the listed companies, a 48 hours notice of the meeting of the Board of directors for passing resolution for determination of price is given to the regional stock exchange.

**3.5.4** The final offer document, shall contain only one price and one set of financial projections, if applicable.



## UNIT 5: 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.

### 5.1 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.

### 5.2 PROVISIONS IN THE COMPANIES ACT AFFECTING UNDERWRITING

*Disclosure in the Prospectus* - According to 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 therefor should be stated. In addition, particulars of any commission paid or payable to any Director, Manager, or their associates should be disclosed.

### 5.3 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	<u>1,200</u>	<u>1,050</u>	<u>750</u>
	2,800	2,450	1,750
Marked applications	<u>2,000</u>	<u>1,000</u>	<u>2,000</u>



### Company Accounts

Balance	800	1,450	—250
Credit to A and B for C's surplus (ratio 40:35)	<u>133</u>	<u>117</u>	<u>—250</u>
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 :

	<i>A</i>	<i>B</i>	<i>C</i>
Gross liability	4,000	3,500	2,500
Less: Unmarked applications	<u>2,000</u>	<u>1,000</u>	<u>2,000</u>
	2,000	2,500	500
Less: Unmarked applications (Shares in ratio of 20:25:5)	1,200	1,500	300
Net liability	<u>800</u>	<u>1,000</u>	<u>200</u>

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).

#### 5.4 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, 1999 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 applications	Number of Unmarked applications in the ratio of gross liability	Shares Total	Surplus of Clayton in the ratio of 10:6	Total (4)+(5)	Net liability (1)- (6)
	(1)	(2)	(3)	(2) + (3)	(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	-
	<u>20,000</u>	<u>15,000</u>	<u>1,000</u>	<u>16,000</u>	<u>-</u>	<u>16,000</u>	<u>4,000</u>

*Note :* The applications are for 16,000 shares out of which 15,000 are marked. Hence unmarked applications are for 1,000 shares.

**5.5 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 an 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		<u>10,000 shares</u>
		<u>3,50,000 shares</u>

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.



## Advanced Accounting

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)			



## Advanced Accounting

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 THE LIABILITY OF UNDERWRITERS

	Anand	Vijay	Ashok
Gross Liability (No. of shares)	5,00,000	5,00,000	5,00,000
Less : Firm Underwriting	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>
	4,50,000	4,50,000	4,50,000
Less : Marked Applications	<u>4,25,000</u>	<u>4,50,000</u>	<u>3,50,000</u>
	25,000	—	1,00,000
Less : Unmarked Applications (equally)	<u>36,000</u>	<u>—</u>	<u>36,000</u>
	11,000	—	64,000
Less : Adjustment of Anand's surplus	<u>(11,000)</u>	<u>—</u>	<u>11,000</u>
Net liability, excluding firm underwriting	—	—	53,000
Firm underwriting	<u>50,000</u>	<u>50,000</u>	<u>50,000</u>



## Company Accounts

Gross liability	<u>50,000</u>	<u>50,000</u>	<u>1,03,000</u>
<b>(2) Calculation of amounts payable by underwriters</b>			
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	<u>1,25,000</u>	<u>1,25,000</u>	<u>1,25,000</u>
Balance payable	1,00,000	1,00,000	3,38,500
Underwriting Commission Receivable	<u>2,50,000</u>	<u>2,50,000</u>	<u>2,50,000</u>
Amount Paid	1,50,000	1,50,000	—
Amount received by the Co.	<u>—</u>	<u>—</u>	<u>88,500</u>

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
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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





## Advanced Accounting

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	<u>24,000</u>	<u>20,000</u>	<u>12,000</u>	<u>24,000</u>	<u>80,000</u>
	13,500	11,250	19,250	1,000	45,000
Less : Unmarked (in Gross Ratio)	<u>3,000</u>	<u>2,500</u>	<u>2,500</u>	<u>2,000</u>	<u>10,000</u>
	10,500	8,750	16,750	-1,000	35,000
Less : Firm underwriting	<u>4,000</u>	<u>6,000</u>	-	<u>15,000</u>	<u>25,000</u>
	6,500	2,750	16,750	-16,000	10,000
Less : Surplus of 'D' allotted to A B&C 30:25:25	<u>6,000</u>	<u>5,000</u>	<u>5,000</u>	-	-
	500	-2,250	11,750	-	10,000
Surplus of 'B' allotted	<u>500</u>	-	<u>1,750</u>	-	<u>-</u>
Net liability	-	-	<u>10,000</u>	-	<u>10,000</u>

### (iv) Statement of underwriters' liability

Firm	4,000	6,000	-	15,000	25,000
Others	-	-	10,000	-	10,000
	<u>4,000</u>	<u>6,000</u>	<u>10,000</u>	<u>15,000</u>	<u>35,000</u>

### (v) Amounts due from underwriters

	A	B	C	D	Total
Shares to be subscribed as per (iv) above	<u>4,000</u>	<u>6,000</u>	<u>10,000</u>	<u>15,000</u>	<u>35,000</u>
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	<u>75,000</u>	<u>62,500</u>	<u>62,500</u>	<u>50,000</u>	<u>2,50,000</u>
	<u>1,25,000</u>	<u>2,37,500</u>	<u>4,37,500</u>	<u>7,00,000</u>	<u>15,00,000</u>

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



## Company Accounts

'firm' underwriting but including	
Marked applications	90,000 shares
'Firm' underwriting	<u>25,000</u> shares
Total subscription	1,15,000 shares
Less : Marked Applications	<u>80,000</u> shares
Balance being unmarked	<u>35,000</u> shares

### (v) Check:

(a) Taken by public - unmarked applications	10,000 shares
(b) Public through underwriters - marked	80,000 shares
(c) By underwriters - under agreement	<u>35,000</u> shares
	<u>1,25,000</u> 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 contract for issue of shares should be
  - (a) An individual
  - (b) A partnership or company
  - (c) Either (a) or (b)
2. At the time of issuance, 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?



## Advanced Accounting

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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 Equity 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.



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## Company Accounts

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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 6: 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

**6.1 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.

**6.2 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 than 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.

### 6.3 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



## Company Accounts

August 2005. 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, 2006 and the remaining Rs. 20,000 is cancelled on 31st March, 2006. The journal entries to be passed will be the following :

	Rs.	Rs.
<i>1st March, 2006</i>		
(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)		





## Advanced Accounting

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31st March, 2006

8% Debentures A/c	Dr.	20,000	
To Own Debentures A/c			19,200
To Capital Reserve A/c			800
<u>(Cancellation of Rs. 20,000 Debentures)</u>			

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

<i>Dr.</i>		<i>Rs.</i>	<i>Rs.</i>	<i>Cr.</i>	
		<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	
Mar. 1	To Bank-Debentures Purchased	4,850		Jan. 1	By Balance b/d
	To Profit & Loss on cancellation of debenture A/c	150	5,000		50,000
June 30	To Balance c/d		<u>45,000</u>		
			<u>50,000</u>		<u>50,000</u>



## Company Accounts

### Profit & Loss on Cancellation of Debentures

		Rs.			Rs.
June 30	To Capital Reserve (transfer)			Mar. 1	By Debenture Account
		150			150

### Debenture Interest Account

		Rs.			Rs.
Mar. 1	To Bank-Interest for 2 months on Rs. 5,000 Debentures			June 30	By Profit & Loss A/c
		50			1,400
June 30	To Debenture-holders (Interest) A/c				
		<u>1,350</u>			
		<u>1,400</u>			<u>1,400</u>

### Debenture-holders (Interest) A/c

		Rs.			Rs.
June 30	To Cash			June 30	By Debenture interest Account (Interest on Rs. 45,000 @ 6% upto 30th June)
		1,350			1,350

*2nd Half Year*

### 6% Debentures Account

		Rs.	Rs.			Rs.
Aug. 1	To Bank-Debenture Purchased			July 1	By Balance b/d	45,000
			9,975			
	To P & L A/c on Cancellation		25			
Dec. 15	To Bank-Deb. Purchased					
		2,462.50				
	To Profit & Loss on Cancellation of Debentures		<u>37.50</u>			
			2,500			
Dec. 31	To Balance c/d					
			<u>32,500</u>			
			<u>45,000</u>			<u>45,000</u>



## Advanced Accounting

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### Profit & Loss on Cancellation of Debentures A/c

		<i>Rs.</i>			<i>Rs.</i>
Dec. 31	To Capital Reserve —		Aug. 1	By Debenture A/c	25.00
	Transfer	<u>62.50</u>	Dec. 15	By Debenture A/c	<u>37.50</u>
		<u>62.50</u>			<u>62.50</u>

### Debenture Interest Account

		<i>Rs.</i>			<i>Rs.</i>
Aug. 1	To Bank - Interest for one month on Rs. 10,000	50.00	Dec.	By P & L Account	1,093.75
Dec. 15	To Bank	68.75			
Dec. 31	To Debenture holders	<u>975.00</u>			
		<u>1,093.75</u>			<u>1,093.75</u>

### Debenture-holders (Interest) Account

		<i>Rs.</i>			<i>Rs.</i>
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, 2005: 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, 2005.

On February 28, 2006, 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

<i>Dr.</i>		<i>Cr.</i>
2006	Rs. 2006	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

2006	Rs. 2006	Rs.
Feb. 28 To Debenture-holders A/c	10,000	Feb. 28 By Sinking Fund A/c
		10,000

Debentures Redemption Fund Investment Account

2006	Rs. 2006	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)
	<u>10,70,000</u>	<u>1,07,600</u>
		<u>10,70,000</u>



## Advanced Accounting

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### Debenture Interest Account

2006	Rs.	2006	Rs.
Feb. 28 To Cash	10,000	Feb. 28 By Profit & Loss A/c	10,000

### Cash Account

2006	Rs.	2006	Rs.
Feb. To Balance b/d	?	Feb. 28 By Debenture-holders	10,10,000
To Debentures Redemption		By Deb. Interest A/c	10,000
Fund investment A/c	9,62,400	By Balance c/d	?

### Sinking Fund for Redemption of Debentures Account

2006	Rs.	2006	Rs.
Feb. To D.R.F. Investment		Jan. 1 By Balance b/d	10,42,000
Account (Loss)	1,07,600	By Profit & Loss	
To Premium on Redemption		(Appropriation) A/c	75,600
of Debentures A/c	10,000		
To General Reserve	<u>10,00,000</u>		
	<u>11,17,600</u>		<u>11,17,600</u>

### 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, 2005 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.



## Company Accounts

Solution :

### Sencom Limited Debenture Account

2005		Rs.	2005		Rs.
Dec. 31	To Balance c/d	<u>1,50,000</u>	Jan. 1	By Balance b/d	<u>1,50,000</u>
2006			2006		
Mar. 31	To Own Debenture A/c	45,000	Jan. 1	By Balance b/d	1,50,000
	To Balance c/d	<u>1,05,000</u>			
		<u>1,50,000</u>			<u>1,50,000</u>
			Apl. 1	By Balance b/d	1,05,000

### Own Debenture Investment Account

2005		Nominal Interest Cost			2005		Nominal Interest Cost		
		Rs.	Rs.	Rs.			Rs.	Rs.	Rs.
Mar. 1	To Bank	25,000	521	24,725	Mar. 31	By Debenture			
Sep. 1	To Bank	20,000	417	19,708		Interest A/c	—	625	—
Dec. 31	To P & L A/c		1,375		Sep. 30	By Debenture			
						Interest A/c	—	1,125	—
					Dec. 31	By Debenture			
						Interest A/c	—	563	—
						By Balance c/d	45,000	—	44,433
		<u>45,000</u>	<u>2,313</u>	<u>44,433</u>			<u>45,000</u>	<u>2,313</u>	<u>44,433</u>
2006					2006				
Jan. 1	To Balance b/d	45,000	563	44,433	Mar. 31	By Debenture			
Mar. 31	To Capital Reserve					Interest A/c	—	1,125	—
	(Profit on					By 5% Deb. A/c	45,000	—	45,000
	cancellation)	—	—	567					
	To P & L A/c	—	<u>562</u>	—					
		<u>45,000</u>	<u>1,125</u>	<u>45,000</u>			<u>45,000</u>	<u>1,125</u>	<u>45,000</u>



## Advanced Accounting

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Debenture Interest Account					
2005		Rs.	2005	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)	<u>563</u>			
		<u>9,375</u>			<u>9,375</u>
2006			2006		
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)	<u>563</u>	Mar. 31	By P & L A/c	1,876
		<u>3,188</u>			<u>3,188</u>

### Illustration 4

Hindustan Ltd., issued 50,000, 6% Debentures of 100 each on 1st January, 2002. 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, 2005 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.



## Company Accounts

- (c) 1st September, 2005 sold the State Loan of the face value Rs. 40,000 out of loan held on 1st January, 2005 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, 2005 were Rs. 4,67,000.
- Make ledger entries in the books of the company to give effect to the above.

**Solution :**

### Sinking Fund Account

<i>Dr.</i>		<i>Cr.</i>	
<i>2005</i>	<i>Rs. 2005</i>	<i>Rs.</i>	
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 Invest- ment 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	<u>50,000</u>
	<u>1,97,761</u>		<u>1,97,761</u>
		2006	
		Jan. 1 By Balance b/d	1,52,761





## Advanced Accounting

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### Sinking Fund Investment Account 6% State Loan

		Face Value	Cost			Face Value	Cost
		Rs.				Rs.	Rs.
2005				2005			
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				
			<u>1,40,000</u>			<u>1,40,000</u>	<u>1,31,911</u>

2005			
Jan. 1	To Balance b/d	1,00,000	93,911

### Own Debenture (S.F.) Account

		Face Value	Cost			Face Value	Cost
		Rs.				Rs.	Rs.
2005				2005			
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			<u>45,000</u>	<u>45,000</u>
			<u>45,000</u>				

### Interest on S.F. Investment Account

		Rs.			Rs.
2005			2005		
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			
			1998		
			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)	<u>1,500</u>
					<u>10,600</u>
2006					
Jan. 1	To Balance b/d	1,500			



## Company Accounts

### Debenture Interest Account

2005		Rs.	2005		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)	<u>900</u>			
		<u>28,020</u>			<u>28,020</u>

### Sinking Fund Cash Account

2005		Rs.	2005		Rs.
Jan. 1	To Balance b/d	7,680	Jan. 1	By Interest of S.F. Investment A/c (on Rs. 60,000 for 3 months)	900
Mar. 31	To Bank-transfer	50,000			
	To Interest on S.F. Investments	4,200			
Sep. 1	To S.F. Investment 6% State Loan	38,000			
	To Interest on S.F. Investments	1,000	Sep. 1	By S.F. Investment A/c 6% State Loan	56,830
Sep. 30	To Interest on S.F. Investments	<u>3,000</u>	Sep. 1	By Debenture Interest A/c	450
		<u>1,03,880</u>	Dec. 31	By Own Deb. (S.F.) A/c	38,500
			Dec. 31	By Balance c/d	7,200
					<u>1,03,880</u>
2006					
Jan. 1	To Balance b/d	7,200			

### 6% Debentures Account

2005		Rs.	2005		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	<u>4,22,000</u>			
		<u>4,67,000</u>			<u>4,67,000</u>



## Advanced Accounting

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### Notes :

- (1) The amount to be invested on Jan. 1, 2005 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, 2005 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, 2005 :

	<i>Rs.</i>
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, 2005 was the date for redemption of the 2000 debentures, the company started buying own debentures and made the following purchases in the open market :

- 1-2-2005    2,000 debentures at Rs. 98 cum-interest.
- 1-6-2005    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, 2005, 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 2005 :

- (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.)



## Company Accounts

**Solution :**

<b>(a)</b>		<b>Debenture Redemption Fund Account</b>			
<i>2005</i>		<i>Rs.</i>	<i>2005</i>		<i>Rs.</i>
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)	<u>49,73,000</u>	Dec. 31	By 13.5% Deb. in XX Ltd.	2,70,000
		<u>50,23,000</u>		By Own Deb. A/c (Int. on own Deb.)	<u>2,53,000</u>
					<u>50,23,000</u>

### 11% Debentures Account

<i>2005</i>		<i>Rs.</i>	<i>2005</i>		<i>Rs.</i>
Dec. 31	To Own Debentures A/c To Bank	24,00,000 <u>26,00,000</u>	Jan. 1	By Balance b/d	50,00,000
		<u>50,00,000</u>			<u>50,00,000</u>

<b>(b)</b>		<b>Own Debentures Account</b>							
<i>2005</i>		Nominal <i>Rs.</i>	Int. <i>Rs.</i>	Amt. <i>Rs.</i>	<i>2005</i>		Nominal <i>Rs.</i>	Int. <i>Rs.</i>	Amt. <i>Rs.</i>
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	Dec. 31	By Debenture Int. A/c	1,32,000		
June 1	To Bank	2,00,000	9,167	1,98,000	By 11% Deb. Account, cancellation				24,00,000
Dec. 31	To Capital Res. (profit on cancellation)			1,57,833					
	By Deb. Redemp. Fund			<u>2,53,000</u>					
		<u>24,00,000</u>	<u>2,64,000</u>	<u>24,00,000</u>			<u>24,00,000</u>	<u>2,64,000</u>	<u>24,00,000</u>

**Working Note :**

### 13.5% Debentures in XX Ltd.

<i>2005</i>		Interest <i>Rs.</i>	Amount <i>Rs.</i>	<i>2005</i>		Interest <i>Rs.</i>	Amount <i>Rs.</i>
Jan. 1	To Balance b/d			June 30	By Bank	1,35,000	



## Advanced Accounting

	(20,00,000)		19,50,000				1,35,000
Dec. 31	To	Debenture		Dec. 31	By	Bank	19,00,000
		Redemp. Fund	2,70,000		By	Debenture	
						Redemp. Fund	
						(Loss on sale)	50,000
			2,70,000				2,70,000
			19,50,000				19,50,000

### Illustration 6

- (i) Swati Associates Ltd. has issued 10,000 12% Debentures of Rs. 100 each on 1-1-2003. These debentures are redeemable after 3 years at a premium of Rs. 5 per debenture. Interest is payable annually.
- (ii) On October 1, 2004, 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, 2005 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, 2005 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, 2005.

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
		Rs.	Rs.			Rs.	Rs.
2004				2004			
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
2005				2005			
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	



## Company Accounts

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
		<u>36,000</u>	<u>4,73,500</u>		<u>36,000</u> <u>4,73,500</u>

**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

<i>2003</i>	<i>Rs.</i>	<i>2003</i>	<i>Rs.</i>
Dec. 31 To Bank A/c	1,20,000	Dec. 31 By Profit & Loss A/c	1,20,000
2004		2004	
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	<u>18,000</u>		
	<u>1,20,000</u>		<u>1,20,000</u>
<i>2005</i>		<i>2005</i>	
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)	<u>84,000</u>		
	<u>1,11,000</u>		<u>1,11,000</u>

### Profit & Loss A/c (Extracts)

2003	To Deb. Interest A/c	1,20,000			
2004	To Deb. Interest A/c	1,20,000	2004	By Int. on Own Deb. A/c	4,500
				(18,000 - 13,500)	
2005	To Debenture Int. A/c	1,11,000	2005	By Own Deb. A/c	
" Own Debentures A/c				(Profit on cancellation)	10,500
Loss on cancellation			2005	" Interest on Own Deb.	
(4,000 + 12,000)	16,000			A/c (36,000 - 18,000)	18,000
" Premium on Redemption					
of Debentures on					
Rs. 7,00,000 @ 5%	35,000				



## Advanced Accounting

### 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

2003			Rs.	2003		Rs.
Dec. 31	To	Balance c/d	10,00,000	Jan. 1	By	Bank
						10,00,000
2004				2004		
Dec. 31	To	Balance c/d	10,00,000	Jan. 1	By	Balance b/d
						10,00,000
2005				2005		
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	<u>7,00,000</u>			
			<u>10,00,000</u>			<u>10,00,000</u>

### Working Notes :

(i) Interest paid on purchase of own debentures :

<i>Date</i>	<i>Nominal Amount</i>	<i>Period</i>	<i>Rate</i>	<i>Interest</i>
2004 Oct. 1	Rs. 1,50,000	9 months	12%	13,500
2005 Oct. 1	Rs. 2,00,000	9 months	12%	18,000

(ii) Interest Credited to Interest on Own Debenture A/c

2004 Dec. 31	Rs. 1,50,000	12 months	12%	18,000
2006 April 1	Rs. 1,00,000	3 months	12%	3,000
2006 June 30	Rs. 1,50,000	6 months	12%	9,000
2006 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 :

	<i>Rs.</i>		<i>Rs.</i>
Issued and Fully Paid		Sundry Assets	21,55,000
Share Capital : 50,000 6%		Own Debentures (Nominal	



## Company Accounts

Redeemable 'A' Pref. Shares of Rs. 10 each		Rs. 1,20,000)	1,05,000
40,000 7% Redeemable 'B' Pref. Shares of Rs. 10 each (less calls in arrear on 5,000 shares)	5,00,000	Cash at Bank	5,80,000
50,000 Equity shares of Rs. 10 each	3,95,000		
Share Premium Account	5,00,000		
Capital Reserve Account	1,00,000		
Profit and Loss Account	1,00,000		
General Reserve Account	4,00,000		
5% Debentures, 2007	2,00,000		
Creditors	4,00,000		
	<u>2,45,000</u>		
	<u>28,40,000</u>		<u>28,40,000</u>

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.





## Advanced Accounting

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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

<i>Dr.</i>	<i>Rs.</i>	<i>2006</i>	<i>Cr.</i>	<i>Rs.</i>
2006				
Sep. 30 To 6% Debentures A/c	2,00,000	Apl. 1	By Balance b/d	4,00,000
" 5% Debentureholders Account	<u>2,00,000</u>			
	<u>4,00,000</u>			<u>4,00,000</u>

### Own Debentures Account

<i>Dr.</i>	<i>Rs.</i>	<i>2006</i>	<i>Cr.</i>	<i>Rs.</i>
2006				
Apl. 1 To Balance b/d	1,05,000	Sep. 30	By New Own Deb. A/c	1,05,000

### (New) Own Debentures Account

<i>Dr.</i>	<i>Rs.</i>	<i>2006</i>	<i>Cr.</i>	<i>Rs.</i>
2006				
Sep. 30 To (Old) Own Deb. A/c	<u>1,05,000</u>	Sep. 30	By Balance b/d	<u>1,05,000</u>
To Balance c/d	1,05,000			

### 6% Debentures Account

<i>Dr.</i>	<i>Rs.</i>	<i>2006</i>	<i>Cr.</i>	<i>Rs.</i>
2006				
Oct. 31 To Balance b/d	<u>2,00,000</u>	Sep. 30	By 5% Debentures A/c	<u>2,00,000</u>
		Nov. 1	By Balance b/d	2,00,000

### 5% Debentureholders Account

<i>Dr.</i>	<i>Rs.</i>	<i>2006</i>	<i>Cr.</i>	<i>Rs.</i>
2006				
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	<u>20,000</u>
	<u>2,20,000</u>			<u>2,20,000</u>



## Company Accounts

### 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	<u>2,00,000</u>
	<u>4,00,000</u>		<u>4,00,000</u>
		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	
" Dividends A/c	29,000	Oct. 30 " Bank A/c	2,00,000
" Interest on 5% Deb. A/c	10,000		
Oct. 30 " Balance c/d	<u>61,000</u>		
	<u>6,00,000</u>		<u>6,00,000</u>
		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	<u>6,00,000</u>
	<u>11,00,000</u>		<u>11,00,000</u>
		Nov. 1 By Balance b/d	11,00,000

### Share Premium Account



## Advanced Accounting

2006	Rs.	2006	Rs.
Sep. 30	To Premium on Redemp. of Preference Shares A/c	70,000	
"	Premium on Redemp. of Debentures A/c	20,000	
"	Balance c/d	<u>1,60,000</u>	
		<u>2,50,000</u>	
			<u>2,50,000</u>
		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	
Aug. 31	" Equity Share Capital A/c	6,00,000	
"	Share Premium A/c	1,50,000	
Oct. 31	" Profit & Loss A/c	2,00,000	
		<u>15,30,000</u>	
			<u>15,30,000</u>
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
			<u>17,500</u>
			<u>3,67,500</u>



## Company Accounts

### 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	<u>50,000</u>
	<u>5,50,000</u>		<u>5,50,000</u>

### 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	<u>2,500</u>		
	<u>70,000</u>		<u>70,000</u>
		Oct. 1 By Balance b/d	2,500

### Premium on Redemption of Debentures Account

2006	Rs.	2006	Rs.
Sep. 30 To 5% Debentureholders A/c	<u>20,000</u>	Sep. 30 By Share Premium A/c, Transfer	<u>20,000</u>

### Capital Redemption Reserve Account

2006	Rs.	2006	Rs.
Oct. 31 To Balance c/d	<u>3,00,000</u>	Sep. 30 By Profit & Loss A/c	<u>3,00,000</u>
		Nov. 1 By Balance b/d	3,00,000

### Balance Sheet of Chanjit Ltd. as on 31st Oct., 2006

<i>Liabilities</i>	Rs.	<i>Assets</i>	Rs.
Share Capital :		Sundry Assets	21,55,000
Authorised :		<i>Investment</i>	
Issued and Subscribed		Own Debenture (Nominal)	



## Advanced Accounting

1,10,000 Equity Shares of Rs. 10 each fully paid up		11,00,000	value Rs. 1,20,000	1,05,000
7% B Pref. Share Capital (pending redemption)	50,000		<i>Current Assets, Loans and Advances :</i>	
<i>Less : Calls in arrear</i>	<u>5,000</u>	45,000	(A) Current Assets	
<i>Reserve and Surplus :</i>			Cash at Bank	3,53,500
Capital Reserve		1,00,000	(B) Loans and Advance	<i>Nil</i>
Capital Redemption Reserve A/c		3,00,000		
Share Premium		1,60,000		
General Reserve		4,00,000		
Profit & Loss Account		61,000		
<i>Secured Loans : 6% Debentures</i>		2,00,000		
<i>Current Liabilities and Provisions :</i>				
(A) Current Liabilities :				
Creditors		2,45,000		
(B) Provisions :				
Premium payable on redemption of 5,000 B Preference Share		<u>2,500</u>		
		<u>26,13,500</u>		<u>26,13,500</u>

### Illustration 7

The Balance Sheet of BEE CO. LTD. on 31st January, 2006 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	<u>3,00,000</u>	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	<u>20,000</u>		
	<u>5,75,000</u>		<u>5,75,000</u>

At the Annual General Meeting it was resolved :



## Company Accounts

- (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
<u>(Proposed Dividend paid to existing shareholders)</u>			
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
<u>(Application money received on 5,000 shares @ Rs. 15 per share to be issued as rights shares in the ratio of 1:4)</u>			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000
<u>(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...)</u>			
Securities Premium A/c	Dr.	25,000	
Profit & Loss A/c	Dr.	25,000	
To Bonus to Shareholders A/c			50,000



## Advanced Accounting

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(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)

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital</i>		<i>Fixed Assets</i>	
Authorised, Issued & Subscribed :		Property	1,15,000
30,000 shares of Rs. 10 each		<i>Investments</i>	
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)			
<i>Reserve and Surplus</i>			
Profit & Loss A/c	91,400		
Secured Loans	—		
Unsecured Loans	—		
<i>Current Liabilities &amp; Provisions</i>			
Sundry Creditors	<u>1,15,000</u>		
	<u>5,06,400</u>		<u>5,06,400</u>



**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 8**

The summarised Balance Sheet of Convertible Limited, as on 30th June, 2006, stood as follows:

<i>Liabilities</i>	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	<u>1,25,00,000</u>
	<u>4,50,00,000</u>
<i>Assets :</i>	
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	<u>2,00,00,000</u>
	<u>4,50,00,000</u>

The debentures are due for redemption on 1st July, 2006. 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, 2006.

Redraft the balance sheet of the company as on 1st July, 2006 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.





## Advanced Accounting

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Solutions :

### Convertible Limited Balance Sheet as on July 1, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
<i>Share Capital :</i>		<i>Fixed Assets :</i>	
6,00,000 Equity Shares of Rs. 10 each	60,00,000	Fixed Assets (at cost less depreciation)	1,60,00,000
<i>Reserve &amp; Surplus :</i>		<i>Investments :</i>	
<i>General Reserve</i>	1,24,00,000	<i>Current Assets</i>	
Securities Premium Account	5,75,000	<i>Loan &amp; Advances :</i>	
<i>Secured Loans :</i>		Other Current Assets	2,00,00,000
<i>Unsecured Loans :</i>		Cash & Bank Balance	4,75,000
<i>Other Loans</i>	50,00,000	Miscellaneous Expenditure	
<i>Current Liabilities and Provisions :</i>		<i>&amp; Losses :</i>	—
Current Liabilities and Provisions	<u>1,25,00,000</u>		
	<u>3,64,75,000</u>		<u>3,64,75,000</u>

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	<u>25,000</u>
	<u>75,000</u>
20% of 75,000	<u>15,000</u>
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:

Number of debentures	Rs. 1,00,000
Less : number of debentures to be converted into equity shares	<u>15,000</u>
	<u>85,000</u>
Redemption value of 85,000 debentures (85,000 × Rs. 105)	Rs. 89,25,000



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## Company Accounts

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<i>(iii) Cash and Bank Balance :</i>	
Balance before redemption	50,00,000
<i>Add</i> : Proceeds of investments sold	<u>44,00,000</u>
	94,00,000
<i>Less</i> : Cash paid to debenture holders	<u>89,25,000</u>
	<u>4,75,000</u>
<i>(iv) Calculation of General Reserve :</i>	
Opening Balance	75,00,000
<i>Add</i> : Debenture Redemption Fund transfer	<u>50,00,000</u>
	1,25,00,000
Profit on sale of investments	<u>4,00,000</u>
	1,29,00,000
<i>Less</i> : Premium on redemption of debentures	<u>5,00,000</u>
	<u>1,24,00,000</u>

**Note** : The premium on redemption of debentures may also be adjusted against Securities Premium Account.

### 6.4 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 utilised 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, 2005, 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, 2005, the company purchased 1,000 of its 12% Debentures as investment at Rs.99 cum-interest.

On August 01, 2005, it purchased another 1,000 of its debentures at Rs.98 ex-interest. The company cancelled 2,000 own debentures on September 01,2005.

1. Amount debited to Own Debentures Account at the time of purchase on 01.07.2005 = ?
  - (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 01.08.2005 = ?
  - (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



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- (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 :

<i>Liabilities :</i>	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	<u>1,25,00,000</u>
	<u>4,50,00,000</u>
<i>Assets :</i>	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	<u>2,00,00,000</u>
	<u>4,50,00,000</u>

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.



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16. On 1st January, 2004 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 2005 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 2004, the company wrote-off Rs. 5,000 from debenture discount account.

During 2005, 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, 2005. 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 calendar years 2004, 2005 and 2006 :

- (i) Debentures account, (ii) Debentures Redemption account, and (iii) Debentures Interest account. Ignore taxation.



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18. (i) Swati Associates Ltd. has issued 10,000 12% Debentures of Rs. 100 each on 1-1-2002. These debentures are redeemable after 3 years at a premium of Rs. 5 per debenture. Interest is payable annually.
- (ii) On October 1, 2003, it buys 1,500 debentures from the market at Rs. 98 per debenture. These are sold away on June 30, 2004 at Rs. 105 per debenture.
- (iii) On January 1, 2004 it buys 1,000 debentures at Rs. 104 per debenture from the open market. These are cancelled on April 1, 2004.
- (iv) On October 1, 2004 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, 2004.

Prepare the relevant ledger Accounts showing the above transactions. Workings should form part of your answer.

19. 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.





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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 7 AMALGAMATION AND RECONSTRUCTION

### Learning Objectives

After studying this unit, you will be able to

- ◆ Understand and distinguish among the terms amalgamation, absorption and reconstruction.
- ◆ Appreciate the concept of transferee company and the transferor company.
- ◆ Calculate purchase consideration under both the methods of amalgamation as per AS 14.
- ◆ Pass the entries to close the books of the vendor company.
- ◆ Pass the journal entries in the books of purchasing company to incorporate the assets and liabilities of the vendor company and also giving effect to other adjustments.
- ◆ Account the adjustments made at the time of internal reconstruction.

### 7.1 MEANING OF AMALGAMATION AND RECONSTRUCTION

In an amalgamation, two or more companies are combined into one by merger or by one taking over the other. Therefore, the term 'amalgamation' contemplates two kinds of activities (i) two or more companies join to form a new company or (ii) absorption and blending of one by the other. Thus, amalgamations include absorption. In the case of amalgamation the assets and liabilities of transferor company(s) are amalgamated and the transferee company becomes vested with all such assets and liabilities.

Reconstruction is a process by which affairs of a company are reorganised by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganise capital or to compound with creditors or to effect economies. Such a process is called internal reconstruction which is carried out without liquidating the company and forming a new one. However, there may be external reconstruction. Wherever an undertaking is being carried on by a company and is in substance transferred, not to an outsider, but to another company consisting substantially of the same shareholders with a view to its being continued by the transferee company, there is external reconstruction. Such external reconstruction is essentially covered under the category 'amalgamation in the nature of merger' in AS-14.

### 7.2 TYPES OF AMALGAMATION

The Companies Act, 1956 has not specifically defined the term 'amalgamation'. However, from several legal decisions, the definition of amalgamation may be inferred. The Institute of Chartered Accountants of India has introduced Accounting Standard -14 (AS 14) on 'Accounting for



Amalgamations'. The standard recognises two types of amalgamation - (a) amalgamation in the nature of merger and (b) amalgamation in the nature of purchase.

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

- (i) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (ii) Shareholders holding not less than 90% of the face value of the equity shares of the transferor company (other than the equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (iii) The consideration for the amalgamation receivable by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company is discharged by the transferee company wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (iv) The business of the transferor company is intended to be carried on, after the amalgamation, by the transferee company.
- (v) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

If any one or more of the above conditions are not satisfied in an amalgamation, such amalgamation is called *amalgamation in the nature of purchase*.

### 7.3 PURCHASE CONSIDERATION

For the purpose of accounting for amalgamations, we are essentially guided by AS-14 'Accounting for Amalgamations'. Para 3(g) of AS-14 defines the term purchase consideration as the "aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of the transferor company". Therefore purchase consideration does not include the sum which the transferee company will directly pay to the creditors of the transferor company. The purchase consideration essentially depends upon the fair value of its elements. For example, when the consideration includes securities, the value fixed by the statutory authority may be taken as the fair value. In case of other assets, the fair value may be determined by reference to the market value of the assets given up or in the absence of market value, book value of the assets are considered.

Sometimes adjustments may have to be made in the purchase consideration in the light of one or more future events. When the additional payment is probable and can be reasonably estimated it is to be included in the calculation of purchase consideration.



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Example : Let us consider the Balance Sheet of X Ltd. as on 31st March, 2006:

<i>Liabilities</i>	<i>Rs. ('000)</i>	<i>Assets</i>	<i>(Rs. '000)</i>
Share Capital :		Land & Buildings	50,00
Equity Shares of Rs. 10 each	75,00	Plant & Machinery	45,00
14% Preference Shares of		Furniture	10,50
Rs. 100 each	25,00	Investments	5,00
General Reserve	12,50	Stock	23,00
12% Debentures	40,00	Debtors	24,00
Sundry Creditors and other		Cash & Bank balance	15,00
Current liabilities	<u>20,00</u>		
	<u>172,50</u>		<u>172,50</u>

Other Information:

- (i) Y Ltd. takes over X Ltd. on 10th April, 2006.
- (ii) Debentureholders of X Ltd. are discharged by Y Ltd. at 10% premium by issuing 15% own debentures of Y Ltd.
- (iii) 14% Preference Shareholders of X Ltd. are discharged at a premium of 20% by issuing necessary number of 15% Preference Shares of Y Ltd. (Face value Rs. 100 each).
- (iv) Intrinsic value per share of X Ltd. is Rs. 20 and that of Y Ltd. Rs. 30. Y Ltd. will issue equity shares to satisfy the equity shareholders of X Ltd. on the basis of intrinsic value. However, the entry should be made at par value only. The nominal value of each equity share of Y Ltd. is Rs. 10.

Compute the purchase consideration.

**Solution:**

Computation of Purchase consideration	(Rs. in '000)	Form
For Preference Shareholders of X Ltd.	30,00	30,000 15% preference Share in Y Ltd.
For equity shareholders of Y Ltd. ( $2/3 \times 7,50,000$ ) $\times$ Rs. 10	50,00	5,00,000 equity shares of Y Ltd. of Rs. 10 each
	_____	



Total Purchase consideration 80.00

**Note :** Consideration for debenture holders should not be included above. Such debentures will be taken over by Y Ltd. and then discharged.

#### **7.4 METHODS OF ACCOUNTING FOR AMALGAMATIONS**

There are two main methods of accounting for amalgamation:

- (a) The pooling of interests method, and
- (b) The purchase method.

The first method is used in case of amalgamation in the nature of merger and the second method is used in case of amalgamation in the nature of purchase. Under pooling of interests method, the assets, liabilities and reserves of the transferor company will be taken over by transferee company at existing carrying amounts unless any adjustment is required due to different accounting policies followed by these companies. As a result the difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

Under purchase method, the assets and liabilities of the transferor company should be incorporated at their existing carrying amounts or the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation. But no reserves, other than statutory reserves, of the transferor company should be incorporated in the financial statements of transferee company. Statutory reserves of the transferor company should be incorporated in the balance sheet of transferee company by way of the following journal entry.

Amalgamation Adjustment A/c	Dr.
To Statutory Reserves	

When the above statutory reserves will no longer be required to be maintained by transferee company, such reserves will be eliminated by reversing the above entry.

In purchase method any excess of the amount of purchase consideration over the value of the net assets of the transferor company acquired by the transferee company should be recognised as goodwill in the financial statement of the transferee company. Any short fall should be shown as capital reserve. Goodwill should be amortised over period of five years unless a somewhat longer period can be justified.

Example: Consider the following balance sheets of X Ltd. and Y Ltd.



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### Balance Sheet as on 31st March, 2006

<i>Liabilities</i>	<i>X Ltd.</i>	<i>Y Ltd.</i>	<i>Assets</i>	<i>X Ltd.</i>	<i>Y Ltd.</i>
	<i>Rs. '000</i>	<i>Rs. '000</i>		<i>Rs. '000</i>	<i>Rs. '000</i>
Equity Share Capital (Rs. 10 each)	50,00	30,00	Land & Building	25,00	15,50
14% Preference Share Capital (Rs. 100 each)	22,00	17,00	Plant & Machinery	32,50	17,00
General Reserve	5,00	2,50	Furniture & Fittings	5,75	3,50
Export Profit Reserve	3,00	2,00	Investments	7,00	5,00
Investment Allowance Reserve		1,00	Stock	12,50	9,50
Profit & Loss A/c	7,50	5,00	Debtors	9,00	10,30
13% Debentures (Rs. 100 each)	5,00	3,50	Cash & Bank	7,25	5,20
Trade Creditors	4,50	3,50			
Other Current Liabilities	<u>2,00</u>	<u>1,50</u>			
	<u>99,00</u>	<u>66,00</u>		<u>99,00</u>	<u>66,00</u>

X Ltd. takes over Y Ltd. on 1st April, 2006. X Ltd. discharges the purchase consideration as below:

- Issued 3,50,000 equity shares of Rs. 10 each at par to the equity shareholders of Y Ltd.
- Issued 15% preference shares of Rs. 100 each to discharge the preference shareholders of Y Ltd. at 10% premium.

The debentures of Y Ltd. will be converted into equivalent number of debentures of X Ltd. The statutory reserves of Y Ltd. are to be maintained for 2 more years.

Show the balance sheet of X Ltd. after amalgamation on the assumption that:

- the amalgamation is in the nature of merger.
- the amalgamation is in the nature of purchase.

**Solution:**

- Amalgamation in the nature of merger:**

#### Balance Sheet of X Ltd.

<i>Liabilities</i>	<i>Rs. '000</i>	<i>Assets</i>	<i>Rs. '000</i>
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Equity Share Capital (Rs. 100 each)	85,00	Land & Buildings	40,50
15% Preference Share Capital (Rs. 100)	18,70	Plant & Machinery	49,50
14% Preference Share Capital (Rs. 100)	22,00	Furniture & Fittings	9,25
General Reserve	80*	Investments	12,00
Export Profit Reserve	5,00	Stock	22,00
Investment Allowance Reserve	1,00	Debtors	19,30
Profit & Loss A/c	12,50	Cash & Bank	12,45
13% Debentures (Rs. 100 each)	8,50		
Trade Creditors	8,00		
Other current liabilities	<u>3,50</u>		
	<u>165,00</u>		<u>165,00</u>

\*As per para 7.4 above, the difference between the amount recorded as share capital issued and the amount of share capital of transferor company should be adjusted in reserves. Thus,

General Reserve = Rs. '000 [7,50 – (53,70 – 47,00)] = Rs. ('000) 80

**(b) Amalgamation in the nature of purchase :**

### Balance Sheet of X Ltd.

<i>Liabilities</i>	<i>Rs. '000</i>	<i>Assets</i>	<i>Rs. '000</i>
Equity share Capital (Rs. 10)	85,00	Land & Buildings	40,50
15% Preference Share Capital (Rs. 100)	18,70	Plant & Machinery	49,50
14% Preference Share Capital (Rs. 100)	22,00	Furniture & Fittings	9,25
General Reserve	5,00	Investments	12,00
Capital Reserve (working)	3,80	Stock	22,00
Profit & Loss A/c	7,50	Debtors	19,30
Export Profit Reserve	5,00	Cash and Bank	12,45
		Amalgamation Adjustment A/c	3,00



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Investment Allowance Reserve	1,00	
13% Debentures (Rs. 100 each)	8,50	
Trade Creditors	8,00	
Other Current Liabilities	<u>3,50</u>	
	<u>168,00</u>	<u>168,00</u>

**Workings :** Capital Reserve arising on Amalgamation:

(A) Net Assets taken over :	Rs. ('000)	Rs. ('000)
Sundry Assets		66,00
<i>Less</i> : 13% Debentures	3,50	
Trade Creditors	3,50	
Other current liabilities	<u>1,50</u>	
		<u>8,50</u>
		<u>57,50</u>
(B) Purchase consideration :		
To Equity Shareholders of Y Ltd.		35,00
To Preference Shareholders of Y Ltd.		<u>18,70</u>
		<u>53,70</u>
(C) Capital Reserve (A – B)		<u>3,80</u>

### Illustration 1

S. Ltd. is absorbed by P. Ltd. The balance sheet of S. Ltd. is as under :

Balance Sheet			
	Rs.		Rs.
Share Capital :		Sundry Assets	13,00,000
2,000 7% Preference shares			
of Rs. 100 each (fully paid-up)	2,00,000		
5,000 Equity shares of Rs. 100			
each (fully paid-up)	5,00,000		
Reserves	3,00,000		
6% Debentures	2,00,000		
Trade creditors	<u>1,00,000</u>		
	<u>13,00,000</u>		<u>13,00,000</u>

P. Ltd. has agreed :





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- (i) to issue 9% Preference shares of Rs. 100 each, in the ratio of 3 shares of P. Ltd. for 4 preference shares in S. Ltd.
- (ii) to issue to the debenture-holders in S. Ltd. 8% Mortgage Debentures\* at Rs. 96 in lieu of 6% Debentures in S. Ltd. which are to be redeemed at a premium of 20%;
- (iii) to pay Rs. 20 per share in cash and to issue six equity shares of Rs. 100 each (market value Rs. 125) in lieu of every five shares held in S. Ltd.; and
- (iv) to assume the liability to trade creditors.

**Solution :**

**The purchase consideration will be**

	Rs.	Form
Preference shareholders : $2,000 \times \frac{3}{4} \times 100$	1,50,000	9% Pref. Shares
Equity shareholders : $5,000 \times 20$	1,00,000	Cash
$5,000 \times \frac{6}{5} \times 125$	<u>7,50,000</u>	Equity Shares
	<u>10,00,000</u>	

Supposing the total number of fractions arising on exchange aggregate to 20 shares (equivalent to equity shares in P. Ltd.) each will have to be paid for them @ Rs. 125 per share; the remaining amount will be settled by the issue of equity shares. Alternatively, fraction certificates are issued; these are converted into shares on presentation - the holder of the fraction certificates must buy more such certificates or sell those held by him.

### Illustration 2

Y Ltd. decides to absorb X Ltd. The Balance Sheet of X Ltd. is as follows :

	Rs.		Rs.
3,000 Equity shares of		Sundry Net Assets	2,90,000
Rs. 100 each (fully paid)	3,00,000	Profit and Loss Account	70,000
Preference shares	<u>60,000</u>		
	<u>3,60,000</u>		<u>3,60,000</u>

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\* According to AS-14, 'consideration' for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the **shareholders** of the transferor company. Therefore, debentures issued to the debenture holders will not be included in purchase consideration. Like trade creditors, the liability in respect of debentures of S. Ltd. will be taken by P Ltd., which will then be settled by issuing new 8% debentures.



Y Ltd. agrees to take over the net assets of X Ltd. An equity share in X Ltd., for purposes of absorption, is valued @ Rs. 70. Y Ltd. agrees to pay Rs. 60,000 in cash for payment to preference shareholders and the balance in the form of its equity shares valued at Rs. 120 each.

**Solution :**

Value of 3,000 shares @ Rs. 70 = Rs. 2,10,000

The purchase consideration will be :

Net Assets = Rs. 2,10,000 + Liability towards preference shareholders  
= Rs. 2,10,000 + Rs. 60,000 = Rs. 2,70,000

Rs. 60,000 out of the above will be in cash and Rs. 2,10,000 in the form of shares in X Ltd., issued at Rs. 120 per share; the number of shares that will be issued : 2,10,000/120 = 1,750.

**Illustration 3**

Suppose in Illustration 2, Y Ltd. already holds in X Ltd. 1000 equity shares. The purchase consideration will be :

**Amount required to pay to outside shareholders :**

	<i>Rs.</i>
2,000 shares @ Rs. 70 (in the form of shares)	1,40,000
Amount required to be paid in cash	<u>60,000</u>
	<u>2,00,000</u>

The total number of shares to be issued =  $\frac{1,40,000}{120} = 1,166 \frac{2}{3}$  ; 1166 shares will be issued;

cash will be paid for 2/3 share i.e. Rs. 80.

**Note :** At the time of passing entries for the purchase of business, the account representing the investment must be credited to make it nil.

**7.5 Journal Entries to Close the Books of Vendor Company**

These will be illustrated with the following case.

Wye Ltd. acquires the business of Z Ltd. whose balance sheet on 31st December, 2006 is as under :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share capital divided into		Goodwill	2,00,000



## Advanced Accounting

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shares of Rs. 100 each		Land & Buildings	4,00,000
6% Preference share capital	4,00,000	Plant and Machinery	6,00,000
Equity share capital	8,00,000	Patents	50,000
Capital Reserve	1,00,000	Stock	1,50,000
Profit & Loss A/c	50,000	Books Debts	1,80,000
6% Debentures	2,00,000	Cash at Bank	70,000
Interest outstanding on above	12,000	Underwriting Commission	40,000
Workmen's Compensation Reserve (Expected liability Rs. 5,000)	8,000		
Trade Creditors	<u>1,20,000</u>		
	<u>16,90,000</u>		<u>16,90,000</u>

Wye Ltd. was to take over all assets (except cash) and liabilities (except for interest due on debentures) and to pay following amounts :

- (i) Rs. 2,00,000 7% Debentures (Rs. 100 each) in Wye Ltd. for the existing debentures in Zed Ltd.; for the purpose, each debenture of Wye Ltd. is to be treated as worth Rs. 105.
- (ii) For each preference share in Zed Ltd. Rs. 10 in cash and one 9% preference share of Rs. 100 each in Wye Ltd.
- (iii) For each equity share in Zed Ltd. Rs. 20 in cash and one equity share in Wye Ltd. of Rs. 100 each having the market value of Rs. 140.
- (iv) Expense of liquidation of Zed Ltd. are to be reimbursed by Wye Ltd. to the extent of Rs. 10,000. Actual expenses amounted to Rs. 12,500.

Wye Ltd. valued Land and building at Rs. 5,50,000 Plant and Machinery at Rs. 6,50,000 and patents at Rs. 20,000.

### **Purchase Consideration :**

		Rs.		
(i) Preference Shares :Rs. 10 per share	40,000			Cash
Preference shares	<u>4,00,000</u>	4,40,000		Preference shares
(ii) Equity shares :Rs. 20 per share	1,60,000			Cash
8,000 equity shares in Wye Ltd. @ Rs. 140	<u>11,20,000</u>	<u>12,80,000</u>		Equity shares
		<u>17,20,000</u>		



**Steps to close the Books of the Vendor Company**

1. Open Realisation Account and transfer all assets at book value.

*Exception* : If cash is not taken over by the purchasing company, it should not be transferred.

*Note* : Profit and Loss Account (Dr.) and expenses not written off are not assets and should not be transferred to the Realisation Account.

The journal entry in the above case is :

	Rs.	Rs.
Realisation A/c	Dr. 15,80,000	
To Sundries —		
Goodwill		2,00,000
Land & Building		4,00,000
Plant & Machinery		6,00,000
Patents		50,000
Stock		1,50,000
Book debts		1,80,000

(Transfer of assets to Realisation Account on sale of business to Wye Ltd.)

2. Transfer to the Realisation Account the liabilities which the purchasing company is to take over. In case of the provisions, the portion which represents liability expected to arise in future should be so transferred and the portion which is not required (*i.e.*, the reserve portion) should be treated as profit. Accordingly, the following entry will be recorded :

	Rs.	Rs.
6% Debentures in Wye Ltd.	Dr. 2,00,000	
Workmen's Compensation Reserve	Dr. 5,000	
Trade Creditors	Dr. 1,20,000	
To Realisation A/c		3,25,000

(Transfer of liabilities taken over by Wye Ltd. to Realisation A/c)

3. Debit purchasing company and credit Realisation Account with the purchase consideration.

Wye Ltd.-	Dr. 17,20,000	
To Realisation A/c		17,20,000

(Amount receivable from Wye Ltd. for sale of business)



## Advanced Accounting

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4. On receipt of the purchase consideration debit what is received (cash, debentures, shares etc.) and credit the purchasing company. Thus —

Cash	Dr.	2,00,000	
9% Preference shares in Wye Ltd.	Dr.	4,00,000	
Equity shares in Wye Ltd.	Dr.	11,20,000	
To Wye Ltd.			17,20,000

(Receipt of purchase consideration from  
the purchase company)

5. Expenses of liquidation have to be dealt with according to the circumstances of each case. If the vendor company has to bear them, Realisation Account should be debited and Cash Account credited.

If the expenses are to be borne by the purchasing company, the question may be dealt within one of the two ways mentioned below :

- (i) It may be ignored in the books of the vendor company.
- (ii) If the expenses are to be paid first by the vendor company and afterwards reimbursed by the purchasing company, the following two entries will be passed :
  - (a) Debit Purchasing company and credit Cash Account when expenses are paid by the vendor company; and
  - (b) Debit Cash Account and credit purchasing company (on the expenses being reimbursed).

In the above mentioned case Wye Ltd. has to pay maximum of Rs. 10,000 only whereas, the amount spent is Rs. 12,500. Hence Rs. 2,500 is to be borne by Zed Ltd.; the entries required will be :

		Rs.	Rs.
Wye Ltd.	Dr.	10,000	
Realisation A/c	Dr.	2,500	
To Cash A/c			12,500
(Liquidation expenses out of which <u>Rs. 10,000 is payable by Wye Ltd.</u> )			
Cash A/c	Dr.	10,000	
To Wye Ltd.			10,000
<u>(Account reimbursed by Wye Ltd. for expense)</u>			



## Company Accounts

6. Liabilities not assumed by the purchasing company, have to be paid off. On payment, debit the liability concerned and credit cash. Any difference between the amount actually paid and the book figure must be transferred to the Realisation Account. Zed Ltd. shall pass the following entries in this respect :

		Rs.	Rs.
Interest Outstanding	Dr.	12,000	
To Debentureholders A/c			12,000
(Amount due to debenture holders for debentures interest)			
Debentureholders	Dr.	12,000	
To Cash A/c			12,000
(Debentureholders paid cash Rs. 12,000 for outstanding interest)			

7. Credit the preference shareholders with the amount payable to them, debiting Preference Share Capital with the amount shown in the books, transferring the difference between the two, if any, to the Realisation Account. Thus —

6% Pref. Share Capital A/c	Dr.	4,00,000	
Realisation A/c	Dr.	40,000	
To Preference Shareholders A/c			4,40,000
(The amount due to preference shareholders for capital and the extra amount payable under the <u>scheme of absorption</u> )			

*Note* : In the absence of any indication to the contrary, preference shareholders will be entitled only to the capital contributed by them. But if funds available after paying off creditors are not sufficient to satisfy the claim of preference shareholders fully, they will have to suffer a loss to the extent of the deficit.

8. Pay off preference shareholders by debiting them and crediting whatever is given to them. The entry in the above case is :

		Rs.	Rs.
Preference shareholders A/c	Dr.	4,40,000	
To Cash A/c			40,000



## Advanced Accounting

To 9% Preference shares in Wye Ltd. 4,00,000

(Cash and preference shares in Wye Ltd.  
given to preference shareholders)

9. Transfer equity share capital and account representing profit or loss (including the balance in Realisation Account) to Equity Shareholders Account. This will determine the amount receivable by the equity shareholders. Zed Ltd. shall pass the following entries in this regard :

		Rs.	Rs.
Equity Share Capital A/c	Dr.	8,00,000	
Capital Reserve A/c	Dr.	1,00,000	
Profit and Loss A/c	Dr.	50,000	
Workmen's Compensation Reserve A/c	Dr.	3,000	
Realisation A/c	Dr.	4,22,500*	
To Sundry Equity Shareholders A/c			13,75,500
(Various accounts representing capital and profit transferred to Equity Shareholders Account)			
<hr/>			
Equity Shareholders A/c	Dr.	40,000	
To Underwriting Commission A/c			40,000
(Underwriting Commission A/c closed by transfer to Equity Shareholders A/c)			
<hr/>			

\*The Realisation Account will appear as follows :

### Realisation Account

	Rs.			Rs.
To Sundry Assets	15,80,000	By Sundry Liabilities		3,25,000
To Cash (excess expenses of liquidation)	2,500	By Wye Ltd.		17,20,000
To Preference Shareholders	40,000			
To Equity Shareholders A/c - profit transferred	<u>4,22,500</u>			
	<u>20,45,000</u>			<u>20,45,000</u>



## Company Accounts

10. On satisfaction of the claims of the equity shareholders, debit their account and credit whatever is given to them. Hence:

Equity Shareholders A/c	Dr.	13,35,500	
To Equity Shares in Wye Ltd.			11,20,000
To Cash A/c**			2,15,500

### 7.6 ENTRIES IN THE BOOKS OF PURCHASING COMPANY

1. Debit Business Purchase Account and Credit Liquidator of the vendor company with the account of the purchase consideration. Thus -

		Rs.	Rs.
Business Purchase A/c	Dr.	17,20,000	
To Liquidator of Zed Ltd.			17,20,000

(Amount payable to Zed Ltd. as per agreement dated....)

2. (i) Debit assets acquired (except goodwill) at the value placed on them by the purchasing company;
- (ii) Credit liabilities taken over at agreed values and credit Business Purchase Account with the amount of purchase consideration; and
- (iii) Credit the account showing shares held in the company, if any, with the cost of such shares.
- (iv) If the creditors as per (ii) and (iii) above exceed debits as per (i) above, the difference should be debited to Goodwill Account, in the reverse case, the difference should be credited to Capital Reserve.

**Note :** The amount of Goodwill or Capital Reserve that shall be included will be the amount as has been arrived at only in foregoing manner.

In the above case the entry to be passed shall be:

		Rs.	Rs.
Sundries	Dr.		
Land and Building A/c		5,50,000	

\*\* The students should prepare Cash Account to ascertain the cash balance.





## Advanced Accounting

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Plant and Machinery A/c	6,50,000	
Patents A/c	20,000	
Stock A/c	1,50,000	
Sundry Debtors	1,80,000	
Goodwill	5,05,000	
To Sundries		
Provision for Workmen's Compensation A/c		5,000
Trade Creditors		1,20,000
Debentures in Z Ltd.		2,10,000
Business Purchases Account		17,20,000
(Various assets and liabilities taken over from Zed Ltd. Goodwill ascertained as a balancing figure)		

3. On the payment to the vendor company the balance at its credit, the entry to be made by Wye Ltd. shall be:

	Dr.	Rs.	Rs.
Liquidator of Zed Ltd.	Dr.	17,20,000	
To Cash			2,00,000
To 9% Preference Share Capital A/c			4,00,000
To Equity Share Capital A/c			8,00,000
To Securities Premium A/c			3,20,000
(Payment of cash and issue of shares in satisfaction of purchase <u>consideration</u> )			

4. Debentures in Z Ltd. A/c	Dr.	2,10,000	
To 7% Debentures A/c			2,00,000
To Premium on Debentures A/c			10,000

5. If the purchasing company is required to pay the expenses of liquidation of the vendor company, the amount should be debited to the Goodwill or Capital Reserve Account, as the case may be. In the instant case, the entry shall be:



## Company Accounts

Goodwill Account	Dr.	10,000	
To Cash Account			10,000

(Amount paid towards liquidation expenses on Zed Ltd.)

*Entries at par value* - The students will note that purchasing company is left with a large debit in the Goodwill Account (Step No. 2) accompanied by quite a large amount in the Securities Premium Account (Step No. 3). The two cannot be adjusted. However, it would be permissible to negotiate on the basis to the market value of the shares but to make entries only on the basis of par of shares of purchasing company. This will mean that Goodwill Account (or Capital Reserve) will be automatically adjusted for the share premium.

*Inter Company-owing* - Should the purchasing company owe an amount to the vendor company or *vice versa*, the amount will be included in the book debts of one company and creditors of the other. This should be adjusted by the entry:

Sundry Creditors	Dr.	
To Sundry Debtors		

The entry should be made after the usual acquisition entries have been passed. At the time of preparing the Realisation Account and passing the business purchase entries, no attention need be paid to the fact that the two companies involved owed money mutually.

*Adjustment of the value of stock* - Inter-company owings arise usually from purchase and sale of goods; it is likely, therefore, that at the time, of the sale of business, the debtor company also has goods in stock which it purchased from the creditor company - the cost of the debtor company will include the profit made by the creditor company. After the takeover of the business it is essential that such a profit is eliminated. The entry for this will be made by the purchasing company. If it is the vendor company which has such goods in stock, at the time of passing the acquisition entries, the value of the stock should be reduced to its cost to the company which is acquiring the business; automatically goodwill or capital reserve, as the case may be, will be adjusted. But if the original sale was made by the vendor company and the stock is with the company acquiring the business, the latter company will have to debit Goodwill (or Capital Reserve) and credit stock with the amount of the profit included in the stock.

### Illustration 4

The following Balance Sheets are given as on 31st March, 2006:

<i>(Rs. in lakhs)</i>		<i>(Rs. in lakhs)</i>	
Best	Better	Best	Better
Ltd.	Ltd.	Ltd.	Ltd.
Rs.	Rs.	Rs.	Rs.



## Advanced Accounting

Share Capital:			Fixed Assets	25	15
Shares of Rs. 100, each			Investments	5	–
fully paid	20	10	Current Assets	20	5
Reserve and Surplus	10	8			
Other Liabilities	<u>20</u>	<u>2</u>			
	<u>50</u>	<u>20</u>		<u>50</u>	<u>20</u>

The following further information is given —

- Investments of Best Ltd. include Rs. 3 lakhs representing shares in Better Ltd. having a face value of Rs. 2 lakhs.
- Better Limited issued shares on 1st April, 2006, in the ratio of one share for every two held, out of Reserves and Surplus.
- It was agreed that Best Ltd. will take over the business of Better Ltd., on the basis of the latter's Balance Sheet, the consideration taking the form of allotment of shares in Best Ltd.
- The value of shares in Best Ltd. was considered to be Rs. 150 and the shares in Better Ltd. were valued at Rs. 100 after the issue of the bonus shares. The allotment of shares is to be made on the basis of these values.
- Liabilities of better Ltd., included Rs. 1 lakh due to Best Ltd., for purchases from it, on which Best Ltd., made profit of 25% of the cost. The goods of Rs. 50,000 out of the said purchases, remained in stock on the date of the above Balance Sheet.

Make the closing ledger in the Books of Better Ltd. and the opening journal entries in the Books of Best Ltd., and prepare the Balance Sheet as at 1st April, 2000 after the takeover.

**Solution :**

### LEDGER OF BETTER LIMITED

#### Fixed Assets Account

	Rs.		Rs.
To Balance b/d	<u>15,00,000</u>	By Realisation A/c (transfer)	<u>15,00,000</u>

#### Current Assets Account

	Rs.		Rs.
To Balance b/d	<u>5,00,000</u>	By Realisation A/c (transfer)	<u>5,00,000</u>



## Company Accounts

<b>Liabilities Account</b>			
	Rs.		Rs.
To Realisation A/c	<u>2,00,000</u>	By Balance b/d	<u>2,00,000</u>
<b>Realisation Account</b>			
To Fixed Assets A/c	15,00,000	By Liabilities A/c	2,00,000
" Current Assets A/c	5,00,000	" Best Limited	15,00,000
		(Purchase Consideration)	
		" Shareholders' A/c	3,00,000
		(Loss on Realisation)	
	<u>20,00,000</u>		<u>20,00,000</u>
<b>Share Capital Account</b>			
To Sundry shareholders		By Balance b/d	10,00,000
A/c - (transfer)	15,00,000	" Reserves & Surplus A/c	
		(Bonus issue)	<u>5,00,000</u>
	<u>15,00,000</u>		<u>15,00,000</u>
<b>Reserves &amp; Surplus A/c</b>			
To Share Capital (Bonus issue)	5,00,000	By Balance b/d	8,00,000
" Sundry Shareholders	<u>3,00,000</u>		
	<u>8,00,000</u>		<u>8,00,000</u>
<b>Best Ltd.</b>			
To Realisation A/c - Purchase		By Sundry Shareholders (1/5	
Consideration	15,00,000	of Purchase Consideration)	3,00,000
		" Shares in Best Ltd.	<u>12,00,000</u>
	<u>15,00,000</u>		<u>15,00,000</u>
<b>Shares in Best Ltd.</b>			
To Best Ltd.	12,00,000	By Sundry Shareholders A/c	12,00,000



## Advanced Accounting

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Sundry Shareholders A/c			
To Realisation A/c	3,00,000	By Share Capital A/c	15,00,000
(Loss)		" Reserves & Surplus A/c	3,00,000
" Best Ltd.	3,00,000		
" Share in Best Ltd.	<u>12,00,000</u>		
	<u>18,00,000</u>		<u>18,00,000</u>

### JOURNAL OF BEST LTD.

		<i>Dr.</i>	<i>Cr.</i>
2000		Rs.	Rs.
Apr. 1	Fixed Assets A/c	Dr.	15,00,000
	Current Assets A/c	Dr.	5,00,000
	To Liabilities A/c		2,00,000
	To Liquidator of Better Ltd.		12,00,000
	To Capital Reserve A/c		3,00,000
	To Shares in Better Ltd.		3,00,000
	(Assets & Liabilities of Better Ltd. taken over for an agreed purchase consideration of Rs. 12,00,000 and cancellation of investments, held in Better Ltd., at Rs. 3,00,000 as per agreement dated....)		
	Liquidator of Better Ltd.	Dr.	12,00,000
	To Share Capital A/c		8,00,000
	To Securities Premium A/c		4,00,000
	(Discharge of Purchase consideration by the issue of equity shares of Rs. 8,00,000 at a premium of Rs. 50 per share as per agreement)		
	Sundry Creditors A/c	Dr.	1,00,000
	To Sundry Debtors A/c		1,00,000
	(Amount due from Better Ltd., and included in its creditors taken over, cancelled against own sundry debtors)		



## Company Accounts

Capital Reserve A/c	Dr.	10,000	
To Current Asset (Stock) A/c			10,000
(Unrealized profit on stock included in current assets of Better Ltd. written off to Reserve Account)			

### Working Note

*Calculation of Purchase consideration :*

	Rs.
Issued Capital of Better Ltd. (after bonus issue) at Rs. 100 per share	15,00,000
Less : held by Best Ltd.	<u>3,00,000</u>
Held by outsiders, valued at Rs. 100 per share	<u>12,00,000</u>

Purchase consideration has been discharged by Best Ltd. by the issue of shares for Rs. 8,00,000 at a premium of Rs. 4,00,000. This gives the value of Rs. 150 per share.

### Balance Sheet of Best Ltd. (After absorption)

	Rs.		Rs.	Rs.
Share Capital				
Authorised				
... shares of Rs. 100 each				
Issued & Subscribed -		Fixed Assets		
28,000 shares of Rs. 100		Opening Balance	25,00,000	
each fully paid	28,00,000	Acquired during		
Of the above (8,000 shares		the year	<u>15,00,000</u>	40,00,000
have been issued for		Investment		2,00,000
consideration other than cash)		Current Assets		23,90,000
Reserves & Surplus :				
Securities Premium	4,00,000			
Capital Reserves	2,90,000			
Other Reserves and Surplus	10,00,000			



## Advanced Accounting

Current Liabilities	<u>21,00,000</u>	
	<u>65,90,000</u>	<u>65,90,000</u>

### Illustration 5

The following are the summarized Balance Sheets of M Ltd. and N Ltd :

	<i>M Ltd.</i>	<i>N Ltd.</i>		<i>M Ltd.</i>	<i>N Ltd.</i>
	Rs.	Rs.		Rs.	Rs.
Share Capital	32,000	28,000	Sundry Assets	42,000	33,000
Profit and Loss A/c	5,000	-	Shares in N Ltd.	20,000	
Creditors	15,000	6,000	Profit and Loss A/c	-	1,000
Loan-H Ltd.	<u>10,000</u>	-			
	<u>62,000</u>	<u>34,000</u>		<u>62,000</u>	<u>34,000</u>

The whole of the shares of M Ltd. are held by H Ltd. and the entire share capital of N Ltd. is held by M Ltd.

A new company MN Ltd., is formed to acquire the sundry assets and creditors of M Ltd. and N Ltd. For this purpose, the sundry assets of M Ltd. are revalued at Rs. 30,000 and those of N Ltd. at Rs. 20,000. The amount of the loan due to H Ltd. is also to be discharged by way of shares in the new company.

Show the journal entries necessary to close the books of M Ltd. and N Ltd.

**Solution :**

### BOOKS OF N LTD.

#### Journal

		<i>Dr.</i>	<i>Cr.</i>
		Rs.	Rs.
Realisation A/c	Dr.	33,000	
To Sundry Assets A/c			33,000
(Sundry Assets transferred to Realisation Account on sale of business to MN Ltd.)			
Creditors A/c	Dr.	6,000	
To Realisation A/c			6,000



## Company Accounts

(Sundry Creditors transferred to Realisation Account on sale of business to MN Ltd.)

MN Ltd. A/c	Dr.	14,000	
To Realisation A/c			14,000

(Amount of purchase consideration receivable from MN Ltd.)

Share Capital A/c	Dr.	28,000	
To Sundry Shareholders (M Ltd.) A/c			28,000

(Amount of Share capital transferred to Sundry Shareholders account)

Sundry Shareholders (M. Ltd.) A/c	Dr.	14,000	
To Realisation A/c			13,000
To Profit & Loss A/c			1,000

(Loss on realisation and debit balance of Profit & Loss Account transferred to Shareholders A/c)

Share in MN Ltd.	Dr.	14,000	
To MN Ltd.			14,000

(Amount of purchase consideration received in shares of MN Ltd.)

Sundry Shareholders (M Ltd.) A/c	Dr.	14,000	
To Shares in MN Ltd. A/c			14,000

(Amount payable to shareholders discharged by issue of shares in MN Ltd.)

### Books of M Ltd.

#### Journal

		Rs.	Rs.
Realisation A/c	Dr.	62,000	
To Sundry Assets A/c			42,000





## Advanced Accounting

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To Shares in N Ltd. A/c		20,000	
(Sundry assets and shares in N Ltd. transferred to Realisation Account on sale of business to MN Ltd.)			
Creditors A/c	Dr.	15,000	
Loan (H Ltd.) A/c	Dr.	10,000	
To Realisation A/c			25,000
(Sundry Creditors and Loan transferred to Realisation Account on sale of business to MN Ltd.)			
MN Ltd. A/c	Dr.	5,000	
To Realisation A/c			5,000
(Amount of purchase consideration receivable from MN Ltd. on transfer of Sundry Assets, Creditors and Loan vide agreement dated...)			
Shares in MN Ltd. A/c	Dr.	5,000	
To MN Ltd. A/c			5,000
(Amount of shares in MN Ltd. received from MN Ltd. in settlement of purchase consideration)			
Shares in MN Ltd. A/c	Dr.	14,000	
To Realisation A/c			14,000
(Amount of shares in MN Ltd. received against investment in shares in N Ltd.)			
Shareholders (H Ltd.) A/c	Dr.	18,000	
To Realisation A/c			18,000
(Loss on realisation transferred to Shareholders Account)			
Share Capital A/c	Dr.	32,000	
Profit & Loss A/c	Dr.	5,000	
To Shareholders (H Ltd.) A/c			37,000

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## Company Accounts

(Balance of Share Capital and Profit & Loss Account transferred to Shareholders Account)

Shareholders (H Ltd.) A/c	Dr.	19,000	
To Shares in MN Ltd.			19,000

(Distribution of the shares received from MN Ltd. and from N Ltd.)

### Working Notes:

#### Books of N Ltd.

(i)	Realisation Account		
	Rs.	Rs.	
To Sundry Assets A/c	33,000	By Creditors	6,000
		By MN Ltd.	14,000
		By Shareholder (M Ltd.) A/c	13,000
		(Loss on Realisation)	
	<u>33,000</u>		<u>33,000</u>

(ii)	Shareholders (M Ltd.) Account		
To Realisation A/c	13,000	By Share Capital	28,000
To Profit & Loss A/c	1,000		
To Shares in MN Ltd.	<u>14,000</u>		
	<u>28,000</u>		<u>28,000</u>

#### Books of M Ltd.

(i)	Realisation Account		
To Sundry Assets	42,000	By Creditors	15,000
To Shares in N Ltd.	20,000	By Loan (H Ltd.)	10,000
		By MN Ltd. (Purchase Consideration)	5,000
		By Shares in MN Ltd.	14,000



## Advanced Accounting

		By Shareholders A/c	18,000
		(Loss on Realisation)	
	<u>62,000</u>		<u>62,000</u>
<b>(ii)</b>	<b>Sundry Shareholder Account</b>		
To Realisation A/c	18,000	By Share Capital A/c	32,000
To Shares in MN Ltd.	<u>19,000</u>	By Profit & Loss A/c	<u>5,000</u>
	<u>37,000</u>		<u>37,000</u>

### Illustration 6

The Balance Sheets of Gonne Ltd. and Drie Ltd. at 31st December, 2005 contain the following:

	Gonne Rs.	Drie Rs.
Authorised and Issued Capital-Shares of Rs. 10 each	5,00,000	3,00,000
Creditors	1,40,000	1,60,000
Debentures, 5 per cent	1,00,000	
Debenture Redemption Fund	50,000	
Profit and Account	(Cr.) 90,000	(Dr.) 70,000
Fixed Assets	5,10,000	3,70,000
Current Assets	3,34,000	50,000
Leasehold Redemption Fund	–	30,000
Investment in Drie Ltd.: 3,000 shares at cost	3,60,000	–

Gonedrie Ltd. is formed to amalgamate the two businesses. The purchase consideration for assets, payable in cash, is agreed at Rs. 10,00,000 for Gonne Ltd. (excluding the shares of Drie Ltd.) and Rs. 4,50,000 for Drie Ltd. In addition, the new company agrees to issue Rs. 1,00,000 6 1/2% Debentures in exchange for the Debentures in Gonne Ltd. The creditors of Gonne Ltd. and Drie Ltd. were paid Rs. 1,35,000 and Rs. 1,58,000 respectively. Close the books of the vendor companies.



Solution:

LEDGER OF DRIE LTD.

Realisation Account

	Rs.		Rs.
To Fixed Assets	3,70,000	By Leasehold Redemption	
To Current Assets	50,000	By Fund Account	30,000
To Sundry Shareholders Account - Profit	<u>62,000</u>	By Gonnedrie Ltd.	4,50,000
	<u>4,82,000</u>	By Sundry Creditors - saving	<u>2,000</u>
			<u>4,82,000</u>

Sundry Creditors Account

	Rs.		Rs.
To Bank	1,58,000	By Balance b/d	1,60,000
" Realisation Account— (balance transferred)	<u>2,000</u>		
	<u>1,60,000</u>		<u>1,60,000</u>

Gonnedrie Ltd.

	Rs.		Rs.
To Realisation Account (purchase consideration)	<u>4,50,000</u>	By Bank	<u>4,50,000</u>

Bank Account

To Gonnedrie Ltd.	4,50,000	By Sundry Creditors	1,58,000
		By Sundry Shareholders A/c	<u>2,92,000</u>
	<u>4,50,000</u>		<u>4,50,000</u>

Sundry Shareholders Account

	Rs.		Rs.
To Profit & Loss A/c - Transfer	70,000	By Share Capital Account	3,00,000
To Bank	<u>2,92,000</u>	By Realisation A/c - Profit	<u>62,000</u>
	<u>3,62,000</u>		<u>3,62,000</u>



## Advanced Accounting

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### LEDGER OF GONNE LTD

#### Realisation Account

	Rs.		Rs.
To Fixed Assets	5,10,000	By Gonnedrie Ltd.	10,00,000
To Current Assets	3,34,000	By 5% Debentures A/c	1,00,000
To Investments in Drie Ltd. - Loss	6,800	By Creditors - saving	5,000
To Sundry Shareholders A/c - Profit	<u>2,54,200</u>		
	<u>11,05,000</u>		<u>11,05,000</u>

#### Gonnedrie Ltd.

	Rs.		Rs.
To Realisation Account - purchase consideration		By Bank	10,00,000
	<u>10,00,000</u>		
	<u>10,00,000</u>		<u>10,00,000</u>

#### Bank Account

	Rs.		Rs.
To Gonndrie Ltd.	10,00,000	By Sundry Creditors	1,35,000
To Investment in Drie Ltd. - amount received from Liquidator of Drie Ltd.		By Sundry Shareholders A/c	8,94,200
	<u>29,200</u>		
	<u>10,29,200</u>		<u>10,29,200</u>

#### Sundry Creditors Account

	Rs.		Rs.
To Bank	1,35,000	By Balance b/d	1,40,000
To Realisation A/c - transfer of balance			
	<u>5,000</u>		
	<u>1,40,000</u>		<u>1,40,000</u>



## Company Accounts

### 5% Debentures Account

	Rs.		Rs.
To Realisation A/c	<u>1,00,000</u>	By Balance b/d	<u>1,00,000</u>

### Investment in Drie Ltd.

	Rs.		Rs.
To Balance b/d	36,000	By Bank	29,200*
	<u>        </u>	By Realisation A/c - loss	<u>6,800</u>
	<u>36,000</u>		<u>36,000</u>

### Sundry Shareholders Account

	Rs.		Rs.
To Bank	8,94,200	By Share Capital A/c	5,00,000
		By Profit & Loss A/c	90,000
		By Debenture Redemption Fund A/c	50,000
	<u>        </u>	By Realisation A/c (Profit)	<u>2,54,200</u>
	<u>8,94,200</u>		<u>8,94,200</u>

### Illustration 7

K Ltd. and L Ltd. amalgamate to form a new company LK Ltd. The financial position of these two companies on the date of amalgamation was as under:

	K Ltd.	L Ltd.		K Ltd.	L Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital			Goodwill	80,000	
Equity Shares			Land & Building	4,50,000	3,00,000
of Rs. 100 each	8,00,000	3,00,000	Plant & Machinery	6,20,000	5,00,000
7% Preference Share			Furniture and		

\* The total amount available for 30,000 shares in Drie Ltd. is Rs. 2,92,000; 3,000 shares are held by Gonne Ltd. Hence 1/10 of Rs. 2,92,000 i.e., Rs. 29,200 will be received from the Liquidator of Drie Ltd.



## Advanced Accounting

of Rs. 100 each	4,00,000	3,00,000	Fittings	60,000	20,000
5% Debentures	2,00,000	—	Sundry Debtors	2,75,000	1,75,000
General Reserve	—	1,00,000	Stores & Stock	2,25,000	1,40,000
Profit and Loss Account	4,31,375	97,175	Cash at Bank	1,20,000	55,000
Sundry Creditors	1,00,000	2,10,000	Cash in hand	41,375	17,175
Secured Loan	—	2,00,000	Preliminary Expenses	60,000	
	<u>19,31,375</u>	<u>12,07,175</u>		<u>19,31,375</u>	<u>12,07,175</u>

The terms of amalgamation are as under:

- (A) (1) The assumption of liabilities of both the Companies.
- (2) Issue of 5 Preference shares of Rs. 20 each in LK Ltd. @ Rs. 18 paid up at premium of Rs. 4 per share for each preference share held in both the Companies.
- (3) Issue of 6 Equity shares of Rs. 20 each in LK Ltd. @ Rs. 18 paid up at a premium of Rs. 4 per share for each equity share held in both the Companies. In addition, necessary cash should be paid to the Equity Shareholders of both the Companies as is required to adjust the rights of shareholders of both the Companies in accordance with the intrinsic value of the shares of both the Companies.
- (4) Issue of such amount of fully paid 6% debentures in LK Ltd. as is sufficient to discharge the 5% debentures in K Ltd. at a discount of 5% after takeover.
- (B) (1) The assets and liabilities are to be taken at book values stock and debtors for which provisions at 2% and 2 ½ % respectively to be raised.
- (2) The sundry debtors of K Ltd. include Rs. 20,000 due from L Ltd.
- (C) The LK Ltd. is to issue 15,000 new equity shares of Rs. 20 each, Rs. 18 paid up at premium of Rs. 4 per share so as to have sufficient working capital. Prepare ledger accounts in the books of K Ltd. and L Ltd. to close their books.



## Company Accounts

Solution :

### BOOKS OF K LTD.

#### Realisation Account

	Rs.		Rs.
To Goodwill	80,000	By 5% Debentures	2,00,000
To Land & Building	4,50,000	By Sundry creditors	1,00,000
To Plant & Machinery	6,20,000	By LK Ltd.	15,60,000
To Furniture & Fitting	60,000	(Purchase consideration)	
To Sundry debtors	2,75,000	By Equity shareholders A/c	51,375
To Stores & Stock	2,25,000	(loss)	
To Cash at Bank	1,20,000		
To Cash in hand	41,375		
To Preference shareholders (excess payment)	<u>40,000</u>		
	<u>19,11,375</u>		<u>19,11,375</u>

#### Equity Shareholders A/c

	Rs.		Rs.
To Preliminary Expenses	60,000	By Share capital	8,00,000
To Realisation A/c (loss)	51,375	By Profit & Loss A/c	4,31,375
To Equity Shares in LK Ltd.	10,56,000		
To Cash	<u>64,000</u>		
	<u>12,31,375</u>		<u>12,31,375</u>

#### LK Ltd. A/c

	Rs.		Rs.
To Realisation A/c	15,60,000	By Equity Shares in LK Ltd.	
		For Equity	10,56,000
		Pref.	<u>4,40,000</u>
		By Cash	<u>64,000</u>
	<u>15,60,000</u>		<u>15,60,000</u>





## Advanced Accounting

### BOOKS OF L LTD.

#### Realisation Account

	Rs.		Rs.
To Land & Building	3,00,000	By Sundry creditors	2,10,000
To Plant & Machinery	5,00,000	By Secured loan	2,00,000
To Furnitures & Fittings	20,000	By LK Ltd. (Purchase	
To Sundry debtors	1,75,000	consideration)	7,90,000
To Stock of stores	1,40,000	By Equity shareholders A/c—	
To Cash at bank	55,000	Loss	37,175
To Cash in hand	17,175		
To Pref. shareholders	<u>30,000</u>		
	<u>12,37,175</u>		<u>12,37,175</u>

#### Equity Shareholders Account

	Rs.		Rs.
To Equity shares in LK Ltd.	3,96,000	By Share Capital	3,00,000
To Realisation	37,175	By Profit & Loss A/c	97,175
To Cash	<u>64,000</u>	By Reserve	<u>1,00,000</u>
	<u>4,97,175</u>		<u>4,97,175</u>

#### LK Ltd. Account

	Rs.		Rs.
To Realisation A/c	7,90,000	By Equity shares in LK Ltd.	
		For Equity	3,96,000
		Preference	<u>3,30,000</u> 7,26,000
		By Cash	<u>64,000</u>
	<u>7,90,000</u>		<u>7,90,000</u>



## Company Accounts

### Working Notes:

#### (i) Purchase consideration

	<i>K Ltd.</i>	<i>L Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Payable to preference shareholders:		
Preference shares at Rs. 22 per share	4,40,000	3,30,000
Equity Shares at Rs. 22 per share	10,56,000	3,96,000
Cash [See W.N. (ii)]	<u>64,000</u>	<u>64,000</u>
	<u>15,60,000</u>	<u>7,90,000</u>

#### (ii) Value of Net Assets

	<i>K Ltd.</i>	<i>L Ltd.</i>
	<i>Rs.</i>	<i>Rs.</i>
Goodwill	80,000	
Land & Building	4,50,000	3,00,000
Plant & Machinery	6,20,000	5,00,000
Furniture & Fittings	60,000	20,000
Debtors less 2 1/2%	2,68,125	1,70,625
Stock less 2%	2,20,500	1,37,200
Cash at Bank	1,20,000	55,000
Cash in hand	<u>41,375</u>	<u>17,175</u>
	18,60,000	12,00,000
Less : Debentures	2,00,000	-
Creditors	1,00,000	2,10,000
Secured Loans	<u>      -</u>	<u>3,00,000</u> <u>2,00,000</u>
	15,60,000	7,90,000
Payable in shares	<u>14,96,000</u>	<u>7,26,000</u>
Payable in cash	<u>64,000</u>	<u>64,000</u>



**Illustration 8**

A Ltd. agreed to acquire the business of B Ltd. as on 31st December, 2005. On that date Balance Sheet of B Ltd. was summarised as follows:

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital (Fully paid shares of Rs. 10 each)	3,00,000	Goodwill	50,000
General Reserve	85,000	Land, Building and Plant	3,20,000
P & L A/c	55,000	Stock-in-trade	84,000
6% Debentures	50,000	Debtors	18,000
Creditors	<u>10,000</u>	Cash & Bank Balance	<u>28,000</u>
	<u>5,00,000</u>		<u>5,00,000</u>

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:

	<i>Rs.</i>
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, 2006. 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, 2006 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, 2006, 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.		Cr.
	Rs.		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	6,37,500
To Stock-in-trade	90,000	consideration (2)	
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	<u>1,97,500</u>		
	<u>7,37,500</u>		<u>7,37,500</u>

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	<u>1,97,500</u>
	<u>6,37,500</u>		<u>6,37,500</u>

Note : It is clear that the costs of liquidation will 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, 2006		28,000
<i>Add:</i> Profit earned		20,000
Depreciation provided (no cash payment)		15,000
Increase in Sundry Creditors		<u>5,000</u>
		68,000
<i>Less:</i> Increase in Stock	6,000	



## Advanced Accounting

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	7,000	13,000
		<u>55,000</u>
(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		<u>625</u>
		<u>6,37,500</u>
(3) Since the transfer of assets is as on 30th June, 2006, the profit of Rs. 20,000 must be standing to the credit of A Ltd.		

### Journal of A Ltd.

	Dr.	Cr.
2006		
July 1 Business Purchase Account	Dr.	
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



## Company Accounts

(Various assets and liabilities taken over from B Ltd. – profit up to June 30, 2006 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 Share 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, 2006 still applies.

### 7.7 ENTRIES IN CASE OF INTERNAL RECONSTRUCTION

On a scheme of reconstruction being adopted (through special resolution confirmed by the Court), the entries to be passed are:

1. Debit Share Account and Credit Capital Reduction Account (or Reconstruction Account or Reorganisation Account), with the amount of the reduction made. However, if the description of the share capital is changed, say, from 6% Preference Share Capital to 7% Preference Share Capital it would be better to :



## Advanced Accounting

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Debit the original Share Capital Account so as to close it, credit new Share Capital Account with the amount treated as paid up; and credit Capital Reduction Account with the difference.

2. An appreciation in the value of an asset or reduction in the amount of a liability should be debited to the account concerned and credited to Capital Reduction Account (which should preferably then be termed as Reconstruction Account).

3. Write off all fictitious assets (including Goodwill and Patents) and eliminate all over-valuation of assets by crediting the accounts concerned and debiting the Capital Reduction (or Reconstruction) Account. For this purpose, any reserve appearing in the books of the company may be used. If any balance is left in the Capital Reduction (or Reconstruction) Account it should be transferred to the Capital Reserve Account.

While preparing the balance sheet of a reconstructed company, the following points are to be kept in mind:

- (a) After the name of the company, the words "and Reduced" should be added *only* if the Court so orders".
- (b) In case of fixed assets, the amount written off under the scheme of reconstruction must be shown for five years.

### Illustration 9

The Balance Sheet of A & Co. Ltd. as on 31-12-2005 is as follows:

	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
Fixed Assets:			
Freehold property		4,25,000	
Plant		50,000	
Patent		37,500	
Goodwill		<u>1,30,000</u>	6,42,500
Traded Investments (at cost)			55,000
Current Assets:			
Debtors		4,85,000	
Stock		4,25,000	
Deferred Advertising		<u>1,00,000</u>	10,10,000
Profit and Loss Account			<u>4,35,000</u>
Total			<u>21,42,500</u>



## Company Accounts

### *Liabilities*

#### Share Capital:

4,000 6% Cumulative Preference Shares of Rs. 100 each	4,00,000	
75,000 Equity Shares of Rs. 10 each	<u>7,50,000</u>	11,50,000
6% Debentures (Secured on Freehold Property)	3,75,000	
Accrued Interest	<u>22,500</u>	3,97,500
Current Liabilities:		
Bank Overdraft	1,95,000	
Creditors	3,00,000	
Directors' Loans	<u>1,00,000</u>	<u>5,95,000</u>
Total		<u>21,42,500</u>

The Court approved a Scheme of re-organisation to take effect on 1-1-2006, whereby:

- (i) The Preference Share to be written down to Rs. 75 each and Equity Shares to Rs. 2 each.
- (ii) Of the Preference Share dividends which are in arrears for four years, three fourths to be waived and Equity Shares of Rs. 2 each to be allotted for the remaining quarter.
- (iii) Accrued interest on debentures to be paid in cash.
- (iv) Debenture-holders agreed to take over freehold property, book value Rs. 1,00,000 at a valuation of Rs. 1,20,000 in part repayment of their holdings and to provide additional cash of Rs. 1,30,000 secured by a floating charge on company's assets at an interest rate of 8% p.a.
- (v) Patents, Goodwill and Deferred Advertising to be written off.
- (vi) Stock to be written off by Rs. 65,000.
- (vii) Amount of Rs. 68,500 to be provided for bad debts.
- (viii) Remaining freehold property to be re-valued at Rs. 3,87,500.
- (ix) Trade Investments be sold for Rs. 1,40,000.
- (x) Directors to accept settlement of their loans as to 90% thereof by allotment of equity shares of Rs. 2 each and as to 5% in cash, and balance 5% being waived.
- (xi) There were capital commitments totalling Rs. 2,50,000. These contracts are to be cancelled on payment of 5% of the contract price as a penalty.
- (xii) Ignore taxation and cost of the scheme.





## Advanced Accounting

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You are requested to show Journal entries reflecting the above transactions (including cash transactions) and prepare the Balance Sheet of the company after completion of the Scheme.

**Solution :**

### Journal of A & Co. Ltd.

		Dr.	Cr.
		Rs.	Rs.
<b>2005</b>			
Dec. 31 Equity Share Capital A/c (Rs. 10)	Dr.	7,50,000	
To Capital Reduction A/c			6,00,000
To Equity Share Capital A/c (Rs. 2)			1,50,000
(Reduction of equity shares of Rs. 10 each to shares of Rs. 2 each as per Reconstruction Scheme dated...)			
<hr/>			
6% Cum. Preference Share Capital A/c (Rs. 100)	Dr.	4,00,000	
To Capital Reduction A/c			1,00,000
To Pref. Share Capital A/c (Rs. 75)			3,00,000
(Reduction of preference shares of Rs. 100 each to shares of Rs. 75 each as per reconstruction scheme)			
<hr/>			
<b>2005</b>			
Dec. 31 Freehold Property A/c	Dr.	82,500	
To Capital Reduction A/c			82,500
(Appreciation in the value of property:			
Book value			Revalued Figure
Rs. 1,00,000			Rs. 1,20,000
<u>Rs. 3,25,000</u>			<u>Rs. 3,87,500</u>
Total		<u>Rs. 4,25,000</u>	<u>Rs. 5,07,500</u>
Profit on revaluation: Rs. 82,500)			
<hr/>			
" 6% Debentures A/c	Dr.	1,20,000	



## Company Accounts

	To Freehold Property A/c		1,20,000
	(Claims of debenture-holders, in part, in respect of principal discharged by transfer of freehold property vide Scheme of Reconstruction)		
	Accrued Interest A/c	Dr.	22,500
	To Bank A/c		22,500
	(Debenture interest paid)		
"	Bank A/c	Dr.	1,30,000
	To 8% Debentures A/c		1,30,000
	(8% Debentures issued for cash)		
"	Bank A/c	Dr.	1,40,000
	To Trade Investment A/c		55,000
	To Capital Reduction A/c		85,000
	(Sale of Trade Investment for Rs. 1,40,000 cost being Rs. 55,000; profit credited to Capital Reduction Account)		
"	Directors' Loan A/c	Dr.	1,00,000
	To Equity Share Capital A/c		90,000
	To Bank A/c		5,000
	To Capital Reduction A/c		5,000
	(Directors' loan discharged by issue of equity shares of Rs. 90,000, cash payments of Rs. 5,000 and surrender of Rs. 5,000, vide Scheme of Reconstruction)		
Dec. 31	Capital Reduction Account	Dr.	24,000
	To Equity Share Capital Account		24,000
	(Arrears of preference dividends satisfied by the issue of equity shares, 25% of the amount due, Rs. 96,000)		



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"	Capital Reduction A/c	Dr.	8,48,500
	To Patents		37,500
	To Goodwill		1,30,000
	To Deferred Advertising		1,00,000
	To Stock		65,000
	To Provision for Doubtful Debts		68,500
	To Bank		12,500
	To Profit & Loss Account		4,35,000

(Writing off patents, goodwill, deferred advertising, profit and loss account and reducing the value of stock, making the required provision for doubtful debts and payment for cancellation of capital commitments)

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### Balance Sheet of A & Co. Ltd. (And Reduced) as on 1st January, 2006

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
<i>Share Capital</i>		<i>Fixed Assets</i>		
1,32,000 Equity shares of		Goodwill	1,30,000	
Rs. 2 each	2,64,000	Less: Amount written		
(Of the above 45,000 shares		off under the Scheme		
have been issued for consi-		of reconstruction	<u>1,30,000</u>	—
deration other than cash)		Freehold Property	4,25,000	
4,000 6% Preference shares of		<i>Add: Appreciation under</i>		
Rs. 75 each	3,00,000	The Scheme of	82,500	
<i>Reserve and Surplus</i>		Reconstruction		
<i>Secured Loans</i>		Less: Disposed of	<u>1,20,000</u>	3,87,500
6% Debentures	2,55,000	Plant		50,000
8% Debentures	1,30,000	Patents	37,500	
Unsecured Loans	—	Less: written off		
<i>Current Liabilities and</i>				



## Company Accounts

<i>Provisions</i>		under the Scheme
Sundry Creditors	3,00,000	of Reconstruction <u>37,500</u> —
		<i>Current Assets,</i>
		<i>Loans and Advances</i>
		A. Current Assets
		Stock in trade 3,60,000
		Sundry Debtors 4,85,000
		<i>Less: Provision</i>
		for Doubtful Debt <u>68,500</u> 4,16,500
		Cash at Bank <u>35,000</u>
	<u>12,49,000</u>	<u>12,49,000</u>

### Illustration 10

S.P. Construction Co. finds itself in financial difficulty. The following is the balance sheet on 31 Dec. 2005.

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	<u>12,800</u>		
	<u>5,11,760</u>		<u>5,11,760</u>

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.



## Advanced Accounting

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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.



## Company Accounts

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	



## Advanced Accounting

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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



## Company Accounts

(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	<u>4,763</u>		
	<u>2,49,554</u>		<u>2,49,554</u>





## Advanced Accounting

### Balance Sheet of S.P. Construction Co. Ltd.

(And reduced) as on .....

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	<u>60,000</u>
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	<u>66,000</u>
Secured Loans		Building	27,246
9 ½% Debentures	89,000	Add Appreciation under	
Unsecured Loans		that Scheme of	
Current Liabilities		Reconstruction	<u>52,754</u>
& provisions		Equipment	80,000
Sundry Creditors	50,247	less written off	10,754
		Under the scheme	
		of reconstruction	<u>754</u>
		Investments	27,000
		sold during the year	<u>27,000</u>
		Current Assets	
		Stock	50,000
		Sundry Debtors	
		(Rs. 7069 written off)	63,623
		Cash at Bank	<u>45,387</u>



## Company Accounts

3,39,010

3,39,010

### Illustration 11

The Balance Sheet of Revise Limited as at 31st March, 2006 was as follows :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	<u>24,000</u>	account	<u>6,00,000</u>
	<u>13,20,000</u>		<u>13,20,000</u>

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 :

- Each share be sub-divided into ten fully paid up equity shares of Rs. 10 each.
- 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.
- 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.
- 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.
- 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.
- Balance of profit and loss account to be written off.
- 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.



## Advanced Accounting

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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			



## Company Accounts

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...

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	<u>24,000</u>		
	<u>7,20,000</u>		<u>7,20,000</u>



**Illustration 12**

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, 2005, the respective Balance Sheets of Star and Moon were as follows :

	Star Rs.	Moon Rs.
Fixed Assets	3,17,500	1,82,500
Current Assets	<u>1,63,500</u>	<u>83,875</u>
	4,81,000	2,66,375
Less: Current Liabilities	<u>2,98,500</u>	<u>90,125</u>
Representing Capital	<u>1,82,500</u>	<u>1,76,250</u>

Additional Information :

(a) Revalued figures of Fixed and Current Assets were as follows :

	Star Rs.	Moon 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
2003 Profit	2,24,788	1,36,950
2004 (Loss)/Profit	(1,250)	1,71,050
2005 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, 2005 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:

	<i>Star</i> Rs.	<i>Moon</i> Rs.
(i) <i>Average Net Profit</i>		
$\frac{2,24,788 - 1,250 + 1,88,962}{3}$	= 1,37,500	
$\frac{1,36,950 + 1,71,050 + 1,79,500}{3}$	=	1,62,500
(ii) <i>Equity Shares Issued</i>		
(a) Ratio of distribution		
Star : Moon		
1,375 : 1,625		
(b) Number		
Star : 13,750		
Moon : 16,250		
	<u>30,000</u>	
(c) Amount		
13,750 shares of Rs. 5 each	= 68,750	
16,250 shares of Rs. 5 each	=	81,250
(iii) <i>Capital Employed (after revaluation of assets)</i>		
Fixed Assets	3,55,000	1,95,000
Current Assets	<u>1,49,750</u>	<u>78,875</u>
	5,04,750	2,73,875
Less: Current Liabilities	<u>2,98,500</u>	<u>90,125</u>
	<u>2,06,250</u>	<u>1,83,750</u>
(iv) <i>Debentures Issued</i>		
8% Return on capital employed	16,500	14,700
15% Debentures to be issued to provide equivalent income :		



## Advanced Accounting

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$$\begin{aligned} \text{Star} &: 16,500 \times \frac{100}{15} &= & 1,10,000 \\ \text{Moon} &: 14,700 \times \frac{100}{15} &= & 98,000 \end{aligned}$$

### (2) Balance Sheet of Neptune Ltd. As at 31st December, 2005

<i>Liabilities</i>	<i>Amount Rs.</i>	<i>Assets</i>	<i>Amount Rs.</i>
Share Capital:		Fixed Assets	5,50,000
Authorised		Current Assets	2,06,950
40,000 Equity Shares of Rs. 5 each	<u>2,00,000</u>		
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 Liabilities	3,66,950		
Provisions	-		
	<u>7,56,950</u>		<u>7,56,950</u>

#### Working Notes :

	<i>Star Rs.</i>	<i>Moon Rs.</i>	<i>Total Rs.</i>
(1) <i>Purchase Consideration</i>			
Equity Shares Issued	68,750	81,250	1,50,000
15% Debentures Issued	<u>1,10,000</u>	<u>98,000</u>	<u>2,08,000</u>
	<u>1,78,750</u>	<u>1,79,250</u>	<u>3,58,000</u>
(2) <i>Capital Reserve</i>			
(a) Net Assets Taken Over			
Fixed Assets	3,55,000	1,95,000	5,50,000



### Company Accounts

Current Assets	<u>1,49,750</u>	<u>57,200*</u>	<u>2,06,950</u>
	5,04,750	2,52,200	7,56,950
Less : Current Liabilities	<u>2,76,825**</u>	<u>90,125</u>	<u>3,66,950</u>
	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

#### Self-examination questions

##### I. Objective Type Questions

Choose the correct answer from the given options

- When the object of reconstruction is usually to re-organise capital or to compound with creditors or to effect economies then such type of reconstruction is called
  - Internal reconstruction with liquidation
  - Internal reconstruction without liquidation of the company
  - External reconstruction
- At the time of amalgamation, purchase consideration does not include
  - The sum which the transferee company will directly pay to the creditors of the transferor company
  - Payments made in the form of assets by the transferee company to the shareholders of the transferor company
  - Preference shares issued by the transferee company to the preference shareholders of the transferor company
- As per AS 14, purchase consideration is the amount agreed payable to
  - Shareholders
  - Shareholders, debenture holders and creditors
  - Shareholders and debenture holders

[Answer: 1-(b), 2-(a), 3-(a),





## Advanced Accounting

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### II. Short Answer Type Questions:

1. Amalgamation and Absorption of companies—a comparison
2. Pooling of interests method of amalgamation

### III. Long Answer Type Questions

1. What are the conditions, which, according to AS 14 on Accounting for Amalgamations, must be satisfied for an amalgamation in the nature of merger?
2. Distinguish between (i) the pooling of interests method and (ii) the purchase method of recording transactions relating to amalgamation.

### IV. Practical Questions

1. (a) The Balance Sheet of Exe Ltd. as at 30th June, 2006 was as follows :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share Capital (shares of		Goodwill	80,000
Rs. 100 each fully paid)	4,00,000	Land and Buildings	1,10,000
General Reserve	80,000	Plant and Machinery	2,50,000
Profit & Loss A/c	38,000	Stock	90,000
Workmen's Compensation Reserve		Book Debts	50,000
(expected Liability Rs. 8,000)	15,000	Underwriting Commission	10,000
Fire Insurance Fund	60,000	Prepaid Expenses	5,000
Creditors	70,000	Cash at Bank	1,18,000
Provision for Taxation	<u>50,000</u>		
	<u>7,13,000</u>		<u>7,13,000</u>

The Company is taken over by Wye Ltd. Determine the purchase consideration in each of the following cases :

- (i) All assets, except cash, are taken over at the values stated in the balance sheet; and liabilities, except that for taxation, are assumed ;
- (ii) Each shareholder is paid at Rs. 20 in cash and is issued shares of Rs. 100 each, valued at Rs. 120 for every five shares held; all assets and liabilities taken over;
- (iii) Each share in Exe Ltd. is valued at Rs. 150, the purchase consideration is to be discharged in the form of shares in Wye Ltd. valued at Rs. 200 (entries being made at par value of Rs. 100).



## Company Accounts

Also show profit or loss on realisation in each case for Exe. Ltd. Assume that the liability for taxation in each case is Rs. 55,000 and expenses of liquidation amount to Rs. 15,000.

- (i) Rs. 5,07,000 : loss on Realisation, Rs. 15,000.
- (ii) Rs. 6,56,000 : Profit on Realisation, Rs. 61,000.
- (iii) Rs. 3,00,000 : Loss on Realisation, Rs. 2,95,000 (real profit being Rs. 5,000 since real value of shares received is Rs. 6,00,000)

(b) What will be the value placed on goodwill by Wye Ltd. in each of the above cases assuming Land & Building to be valued at Rs. 1,50,000 and Plant Machinery at Rs. 2,30,000? (i) Rs. 60,000 (ii) Capital Reserve Rs. 2,20,000.

2. (a) Reckless Ltd. is reconstructed into Careful Ltd. which takes over all assets and liabilities of Reckless Ltd. The Balance Sheet of that company is as under on 31st December 2006 :

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
Share capital (fully paid shares of Rs. 100 each)	10,00,000	Patent Rights	1,20,000
5% Debentures	2,00,000	Plant & Machinery	5,00,000
Creditors	3,00,000	Stock	1,20,000
		Debtors	60,000
		Cash at Bank	5,000
		Profit & Loss A/c	6,85,000
		Discount on issue of Debentures	<u>10,000</u>
	<u>15,00,000</u>		<u>15,00,000</u>

Careful Ltd. is to issue one share of Rs. 20 each as fully paid for each share held in Reckless Ltd. and Debentureholder's in Reckless Ltd. are to receive 6% Debentures of the face value of Rs. 1,15,000. Careful Ltd. will issue to the shareholders additional 20,000 shares of Rs. 20 each. These shares are fully subscribed and out of the sum received Rs. 1,00,000 is paid to the creditors. Patent Rights are valueless and Careful Ltd. is to adjust the value of Plant and Machinery as required.

Give the Balance Sheet Careful Ltd. after all the above arrangements have been put through.

(b) Make entries assuming the above arrangements have been approved by the Court with the formation of a new company.



## Advanced Accounting

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3. The paid-up capital of Toy Ltd. amounted to Rs. 2,50,000 consisting of 25,000 equity shares of Rs. 10 each.

Due to losses incurred by the company continuously, the directors of the company prepared a scheme for reconstruction which was duly approved by the court. The terms of reconstruction were as under:

- (i) In lieu of their present holdings, the shareholders are to receive:
  - (a) Fully paid equity shares equal to 2/5th of their holding.
  - (b) 5% preference shares fully paid-up to the extent of 20% of the above new equity shares.
  - (c) 3,000 6% second debentures of Rs. 10 each.
- (ii) An issue of 2,500 5% first debentures of Rs. 10 each was made and fully subscribed in cash.
- (iii) The assets were reduced as follows:
  - (a) Goodwill from Rs. 1,50,000 to Rs. 75,000.
  - (b) Machinery from Rs. 50,000 to Rs. 37,500.
  - (c) Leasehold premises from Rs. 75,000 to Rs. 62,500.

Show the journal entries to give effect to the above scheme of reconstruction.

4. The following are the Balance Sheets of Yes Ltd. and No Ltd. as on 31st October, 1999 :

	Yes Ltd. Rs. (in crores)	No Ltd. Rs. (in crores)
Sources of funds:		
Share capital:		
Authorised	<u>25</u>	<u>5</u>
Issued and Subscribed :		
Equity Shares of Rs. 10 each fully paid	12	5
Reserves and surplus	<u>88</u>	<u>10</u>
Shareholders funds	100	15
Unsecured loan from Yes Ltd.	<u>—</u>	<u>10</u>
	<u>100</u>	<u>25</u>
Funds employed in :		
Fixed assets: Cost	70	30
Less: Depreciation	<u>50</u>	<u>24</u>
	20	6
Written down value		
Investments at cost:		
30 lakhs equity shares of Rs. 10 each of No Ltd.	3	
Long-term loan to No. Ltd.	10	



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**Company Accounts**

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Current assets	100		34	
Less : Current liabilities	<u>33</u>		<u>15</u>	<u>19</u>
		<u>67</u>		<u>25</u>
		100		25

On that day Yes Ltd. absorbed No Ltd. The members of No Ltd. are to get one equity share of Yes Ltd. issued at a premium of Rs. 2 per share for every five equity shares held by them in No Ltd. The necessary approvals are obtained.

You are asked to pass journal entires in the books of the two companies to give effect to the above.



**UNIT 8 : 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.

**8.1 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 Form 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.



## Advanced Accounting

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- (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.

### 8.2 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.

### 8.3 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.

#### **8.4 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.]



## Advanced Accounting

- (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, 2006 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	<u>4,000</u>	Plant	5,50,000
(Secured by floating charge on all assets)		Fixtures	23,000
Bank Overdraft	25,000	Stock	38,000
(Secured by hypothecation of stock)		Debtors	25,000
Sundry Creditors	<u>36,000</u>	Cash	500
Total	<u>12,25,000</u>	P & L A/c	1,38,500
		Total	<u>12,25,000</u>

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 31-3-2004 Rs.	Year 31-3-2005 Rs.	Year 31-3-2006 Rs.
Gross Profit	<u>65,000</u>	<u>45,000</u>	<u>40,000</u>
Wages and Salaries	40,500	36,000	34,400
Electricity and Water Tax	5,750	6,380	5,260





**Company Accounts**

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	<u>10,500</u>	<u>7,265</u>	<u>7,980</u>
Total	<u>80,990</u>	<u>66,245</u>	<u>63,340</u>

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, 2006**

*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	<u>1,000</u>
	<u>8,56,500</u>

Assets specifically pledged (as per list B)

	(a)	(b)	(c)	(d)
	Estimated	Due to	Deficiency	Surplus car-
	Realisable	secured	ranking as	ried to the
	Value	creditors	unsecured	last column
	Rs.	Rs.	Rs.	Rs.
Stock	31,000	25,000	—	6,000



## Advanced Accounting

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	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	<u>8,56,500</u>		
Total	<u>8,87,500</u>		
<b>Liabilities</b>			
<b>Gross Liabilities</b>			
<i>Rs.</i>		<i>Rs.</i>	<i>Rs.</i>
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 balance of assets available for Debenture holders secured by a floating charge and unsecured creditors)	8,45,500	<u>21,000</u>
1,64,000	Debenture holders secured by floating charge (as per list D)	1,64,000	<u>1,64,000</u>
	Estimated surplus as regards debenture holders* Unsecured creditors (as per list E)	6,81,500	6,81,500
	Estimated unsecured balance of claims of creditors partly secured on specific assets brought forward (c)	Nil	
	Creditors on Trade Account	20,500	
<u>24,000</u>	Outstanding Expenses	<u>3,500</u>	<u>24,000</u>
<u>2,34,000</u>	Estimated surplus as regards creditors, difference between Gross Assets (D) and Gross Liabilities as per column (E)	6,57,500	6,57,500



## Company Accounts

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Issued and called up capital :	
1000 Equity Shares of Rs. 100 each fully called up as per list (G)	<u>10,00,000</u>
Estimated deficiency as regards contributories	<u>3,42,500</u>

\*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	<u>5,000</u>
(6) Other items contributing to deficiency :	<u>2,04,000</u>
Items reducing deficiency :	3,42,500
Deficiency as shown by the Statement of affairs	<u>3,42,500</u>
Notes as to net trading profits and losses :	
Provision for depreciation on fixed assets	6,700
Charged of Income-tax	Nil



## Advanced Accounting

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)	<u>26,875</u>
	<u>60,575</u>

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		<u>5,000</u>
	<u>3,500</u>	<u>21,000</u>

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, 2005:

	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	<u>5,000</u>	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



## Company Accounts

Assets	Estimated to produce Rs.	Book value 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, 2000 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 2001 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 2002, 2003 and 2004. For 2005 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, 2005, the date of winding up.

Assets	Estimated realisable value 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	<u>5,000</u>
	<u>3,03,000</u>



## Advanced Accounting

### *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.	Rs.
Investments	1,70,000	1,90,000	20,000	
Land & Building	<u>1,30,000</u>	<u>80,000</u>		<u>50,000</u>

	Rs.
Estimated surplus from assets specifically pledged	50,000
Estimated total assets available for preferential creditors, debenture holders and unsecured creditors	<u>3,53,000</u>
Summary of Gross Assets:	
Gross realisable value of assets specifically charged	3,00,000
Others assets	<u>3,03,000</u>
	<u>6,03,000</u>
Estimated total assets available for preferential creditors, debenture holders, bank overdraft and unsecured creditors brought forward	3,53,000

Gross Liabilities	Liabilities	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		<u>21,000*</u>
	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		<u>1,02,500</u>
	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	



## Company Accounts

	Trade creditors	2,65,500	
2,93,500	Outstanding expenses	<u>8,000</u>	<u>2,93,500</u>
	Estimated deficiency as regards creditors being the difference between gross liabilities and gross assets		64,000
<u>6,67,000</u>			

### Issued & Called up Capital:

3,000 Equity shares of Rs. 100 each, Rs. 80 paid	2,40,000	
6% 1,000 preference shares of Rs. 100 each fully called	<u>1,00,000</u>	<u>3,40,000</u>
Estimated Deficiency as regards members as per list H.		<u>4,04,000</u>

\* **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 1-1-2003	Nil
2. Net dividend & bonuses during the period Jan.-Dec. 2003	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.



## Advanced Accounting

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	Plant	70,000	
	Tools	16,000	
	Patents	20,000	
	Stock	13,000	
	Investments	10,000	
	Debtors	<u>30,000</u>	1,59,000
6.	Other reducing items contributing to deficiency		<u>NIL</u>
			<u>4,69,000</u>
B. Items reducing Deficiency			
7.	Excess of assets over capital and liabilities on 1st Jan. 2001		15,000
8.	Net trading profit during the period 1st Jan. 2001 to 31st Dec. 2001		40,000
9.	Profit & Incomes other than trading profit during the same period		
10.	Other items Deficiency - Profit expected on Land & Building.		<u>10,000</u>
			65,000
	Deficiency as shown by the statement of Affairs (A) - (B)		<u>4,69,000</u>
			<u>4,04,000</u>

### Working Notes :

#### (1) Trial Balance to ascertain the amount of loss for 2005

	Dr. Rs.	Cr. 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





## Company Accounts

Secretary's Salary	3,000	
Managing Director's Salary	6,000	
Bank Overdraft	<u>1,90,000</u>	
Profit & Loss Account on 1-1-2003	<u>1,23,700</u>	
	8,70,700	10,02,000
Loss for the year (balancing figure)	<u>1,31,300</u>	
	<u>10,02,000</u>	<u>10,02,000</u>

### Reserve & Surplus Account

2000Rs.	2000	Rs.	2001	Rs.	2002
Dec. 31	To Profit & Loss A/c (Transfer)	25,000	Dec. 31	By Balance b/d	40,000
2001 "	Dividend - Equity	24,000	Dec. 31	" Profit for the year	40,000
	Preference	5,700	2002		
2002"	Profit & Loss A/c (Loss)	1,09,000	Dec. 31	" Balance c/d	1,23,700
	" Loss of Stock	<u>40,000</u>			
		<u>2,03,700</u>			<u>2,03,700</u>

### Illustration 3

X Co. Ltd. went into voluntary liquidation on 1st April, 2006. 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		<u>1,20,000</u>
	<u>5,04,000</u>			<u>5,04,000</u>

The following assets are valued as under :

	<i>Rs.</i>
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.



## Advanced Accounting

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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, 2006

Assets not specifically pledged :	Estimated realisable values
Cash in Hand	3,000
Investments	12,000
Debtors	1,40,000
Stock	6,000
Machinery	<u>1,80,000</u>
	<u>3,41,000</u>

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
				<u>1,64,000</u>
				Estimated surplus from assets specifically pledged
				Estimated total assets available for preferential creditors, debentures holders secured by floating charge, and unsecured creditors
				<u>5,05,000</u>
				Summary of Gross assets (d)
				Gross realisable value of assets specifically pledged
				Rs. 2,18,000
				<u>Rs. 3,41,000</u>
				<u>Rs. 5,59,000</u>

(e)

Gross Liabilities	(to be deducted from surplus or added to deficiency as the case may be)	
Rs.	Secured creditors to the extent to which claims are estimated to be covered by assets	
54,000	Specifically pledged	
3,000	Preferential creditors	<u>3,000</u>



## Company Accounts

	Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors	5,02,000
1,50,000	Debentures	<u>1,50,000</u>
	Estimated surplus as regard debenture holders	3,52,000
<u>60,000</u>	Creditors	<u>60,000</u>
<u>2,67,000</u>		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	<u>2,40,000</u>
	Estimated surplus as regard members	<u>52,000</u>

**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.

### 8.5 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.



## Advanced Accounting

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- (iv) Payments made to redeem securities and cost of execution, *i.e.* cost of collecting debts, are deducted from the total receipts.
- (v) Payment are made an 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.

### 8.6 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, 2004 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 2003 and 2004.

Shareholders	Number of shares transferred at the date of ceasing to be member	Date of ceasing to be member	Creditors remaining unpaid and outstanding
X	1,500	1st March 03	4,000
A	1,000	1st May 03	6,000
B	1,500	1st July 03	7,500
C	300	1st Nov. 03	8,000
D	200	1st Feb. 04	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 2003 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, 2003 and 1st July 2003, 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

	A	B	C	D	Amount to be paid to the Creditors
	Shares	Shares	Shares	Shares	Rs.
Creditors Outstanding on the date of ceasing to be member	1,000	1,500	300	200	
(1) 6,000	2,000	3,000	600	400	6,000
(2) 1,500	-	1,125	225	150	1,500



## Advanced Accounting

(3)	500	-	-	300	200	500
(4)	1,500	-	-	-	1,500	50*
	Total (a)	<u>2,000</u>	<u>4,125</u>	<u>1,125</u>	<u>2,250</u>	<u>8,050</u>
(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 2005 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, 2005)		30,000
Trading loss for the year 2005	24,000	
Preference dividend for the year 2005	6,000	
Outstanding Expenses (including mortgage interest)		25,000
4% Mortgage loan		<u>2,00,000</u>
Total	<u>6,30,000</u>	<u>6,30,000</u>

On 1st January, 2006 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, 2006 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.



## Company Accounts

- (2) The loan mortgage was discharged on 31st January, 2006 along with interest from 31st July, 2005. 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, 2006 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, 2006 to 30th June, 2006

	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	<u>2,62,200</u>	Outstanding Expenses	75,500
	4,05,000	Return contributors :	
6 months' interest		6% Preference shareholders	
on debentures	<u>4,200</u>	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	<u>2,000</u>	per share	<u>598</u>
Total	<u>5,33,200</u>	Total	<u>5,33,200</u>

#### Illustration 6

Insol Ltd. is to be liquidated. Their summarised Balance Sheet as at 30th September, 2005 appears as under:

\*  $3/103 \times 2,50,700$  (i.e. Rs.5,32,000 less payments made to all creditors)

\*\* It is assumed that loan is secured by a floating charge.



## Advanced Accounting

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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	<u>35,00,000</u>
	<u>90,00,000</u>
<b>Assets:</b>	
Land and Building	5,00,000
Other fixed assets	20,00,000
Current assets	45,00,000
Profit and Loss A/c	<u>20,00,000</u>
	<u>90,00,000</u>
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 30<sup>th</sup> September, 2005

	Estimated Realisable Value (Rs.)
Assets not specifically pledged: (As per list A)	
Other fixed assets	18,00,000
Current assets	<u>35,00,000</u>
	<u>53,00,000</u>





## Company Accounts

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	<u>1,00,000</u>
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	<u>53,00,000</u>
Gross Assets	Rs. <u>64,00,000</u>

*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)	<u>1,50,000</u>
		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
	Contingent Liability on Bills Discounted	<u>1,00,000</u>
<u>1,00,000</u>	Estimated deficiency as regards creditors (67,50,000—64,00,000)	3,50,000
<u>67,50,000</u>	2,50,000 Equity Shares of	



## Advanced Accounting

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Rs. 10 each : (as per list G)	25,00,000
Estimated deficiency as regards members	<u>28,50,000</u>

### Illustration 7

Prakash Processors Ltd. went into voluntary liquidation on 31st December, 2005 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	<u>3,18,750</u>
	<u>17,43,750</u>
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	<u>2,81,250</u>
	<u>17,43,750</u>

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.



## Company Accounts

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, 2006 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 1-1-99/30-6-99	<u>18,750</u>
Stock	1,50,000		3,06,250
Sundry Debtors	<u>2,00,000</u>	" Preferential creditors	38,000
	12,25,000	" Unsecured creditors	2,80,750
	13,00,000	" Preferential shareholders :	
To Call on equity shareholders		Preference capital	5,00,000
(7,500 × Rs. 2.65) (1)	19,875	Arrear of Dividend	<u>1,00,000</u>
			<u>6,00,000</u>
			12,89,000
		" Equity shareholders -	
		Rs. 12.35 on 2,500 shares	<u>30,875</u>
	<u>13,19,875</u>		<u>13,19,875</u>

**working Notes:**

- (1) Liquidator's remuneration  $12,25,000 \times 3/100 = \text{Rs. } 36,750$   
 (2) As the company is solvent, interest on the debentures will have to be paid for the period 1-1-2006 to 30-6-2006

$$2,50,000 \times \frac{15}{100} \times \frac{1}{2} = \text{Rs. } 18,750$$

- (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



## Advanced Accounting

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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. 2005.

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 2005)			
Assessment year 2003-2004	21,000		
Assessment year 2004-2005	<u>5,000</u>	<u>26,000</u>	
	<u>5,55,500</u>		<u>5,55,500</u>

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



## Company Accounts

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 2003 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 mortgage		Preferential payments	
Sale Proceeds of land and building	1,50,000	Creditors paid - Taxes raised within 12 months	26,000
Less: Applied to discharge of mortgage loan	<u>80,000</u> 70,000	Debentures holders	
		Principal	1,50,000
		Interest for half year	<u>9,750</u> 1,59,750
		Surplus transferred to the Liquidator	<u>82,250</u>
	<u>2,70,000</u>		<u>2,70,000</u>

### Liquidator's Final Statement of Account

	Rs.		Rs.
Surplus received from Receiver	82,250	Cost of Liquidation	2,800
Assets Realised	1,00,000	Remuneration to Liquidator	3,000
Calls on Contributories :		Unsecured Creditors :	
On holder of 5,000 at the rate of Rs. 2.17 per share	10,850	Trade	32,000
		Directors for Bank O/D cleared	<u>30,000</u> 62,000
		Preferential Shareholders :	
		Principal	1,00,000
		Arrears of	



## Advanced Accounting

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	Dividends	22,000	1,22,000
	Equity shareholder :		
	Return of money to contributors to holders of 10,000 shares at 33 paise each		<u>3,300</u>
		<u>1,93,100</u>	<u>1,93,100</u>

### 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		<u>12,500</u>
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

#### *1. 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 ?



## Advanced Accounting

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- (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, 2006.

	<i>Rs.</i>
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 30-6-2004	5,250
For 30-6-2005	1,275





## Company Accounts

For 30-6-2006

2,700

The Reserve of the Company on 1-7-2005 amounted to Rs. 7,500

You are required to prepare:

- (i) Statement of Affairs, and  
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
	2005		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, 2005 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, 2006 when the liquidator made a call on the present and the past contributories to pay the amount.

You are asked to quantify the maximum liability of the transferors of shares mentioned in the above table, when the transferees:

- (i) pay the amount due as "present" member contributories;  
(ii) do not pay the amount due as "present" member contributories.

Also quantify the liability of X to whom shares were transmitted on the demise of his father R.

13. The following was the Balance Sheet of X Limited as on 31.3.2005 :



## Advanced Accounting

### Balance Sheet of X Limited as at 31.3.2005

<i>Liabilities</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>
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	
1. 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
2. Loan on mortgage of land			
and building	1,50,000		
Unsecured Loan	NIL		
Current Liabilities and provisions			
A. Current liabilities			
Sundry creditors	<u>1,17,800</u>		
	<u>14,10,000</u>		<u>14,10,000</u>

On 31.3.2005 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



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## Company Accounts

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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, 2005. Interest on mortgage loan shall be ignored at the time of payment.

Prepare the liquidator's final statement of account.

# CHAPTER 4

## 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 manufacture 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



## Advanced Accounting

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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;



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## Financial Statements of Banking Companies

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- (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 conducive 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 that 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.



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## Financial Statements of Banking Companies

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### 1.6 RESERVE FUNDS (SECTION 17)

Every banking company incorporated in India is required to transfer atleast 20% 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 atleast to the extent of 3% 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.





### **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 existence 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, the cash reserve required to be maintained under Section 18 of the Banking Regulation Act.



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## Financial Statements of Banking Companies

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### 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



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## Financial Statements of Banking Companies

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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

#### *1. 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.
4. Every non-scheduled bank has to maintain a cash reserve of atleast\_\_\_\_\_ of its demand and time liabilities in India
  - (a) 1%
  - (b) 2%



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(c) 3%

(d) 4%

[Answer 1-(d), 2-(b), 3-(a), 4-(c)]

### *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



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## Financial Statements of Banking Companies

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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.



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- (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 :



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- (a) Monthly return of unsecured loans and advances granted to companies in 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



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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)
<b>Capital &amp; Liabilities</b>			
Capital	1		
Reserve & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5	_____	_____
<b>Total</b>		_____	_____
<b>Assets</b>			
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	_____	_____
<b>Total</b>		_____	_____
Contingent liabilities	12		
Bills for collection			



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### Schedule 1 - Capital

	As on 31.3... (Current year)	As on 31.3... (Previous year)
<b>I. For Nationalised Banks</b>		
Capital (Fully owned by Central Government)		
<b>II. For Banks Incorporated outside India</b>		
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	_____	_____
<b>Total</b>	_____	_____
<b>III. For other Banks</b>		
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)		
<i>Less</i> : Calls unpaid		
<i>Add</i> : Forfeited shares	_____	_____
<b>Total</b>	_____	_____



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### Schedule 2 - Reserves and Surplus

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
<b>I. Statutory Reserves</b>		
Opening Balance		
Additions during the year		
Deductions during the year		
<b>II. Capital Reserves</b>		
Opening Balance		
Additions during the year		
Deductions during the year		
<b>III. Share Premium</b>		
Opening Balance		
Additions during the year		
Deductions during the year		
<b>IV. Revenue and other Reserves</b>		
Opening Balance		
Additions during the year		
Deductions during the year		
<b>V. Balance in Profit and loss Account</b>	_____	_____
<b>Total : (I, II, III, IV and V)</b>	_____	_____

### Schedule 3 - Deposits

	As on 31.3... (Current year)	As on 31.3... (Previous year)
<b>A. I. Demand Deposits</b>		
(i) From banks		
(ii) From others		
<b>II. Savings Bank Deposits</b>		



## Financial Statements of Banking Companies

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 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)		





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### 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....

As on 31.3....

(Current year)

(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 : (i, ii & iii)

\_\_\_\_\_

\_\_\_\_\_

Grand Total (I & II) :

\_\_\_\_\_

\_\_\_\_\_

### Schedule 8 - Investments

As on 31.3....

As on 31.3....

(Current year)

(Previous year)

#### I. Investments in India in

(i) Government securities

(ii) Other approved securities

(iii) Shares



## Financial Statements of Banking Companies

(iv) Debentures and Bonds		
(v) Subsidiaries and/or joint ventures		
(vi) Others (to be specified)	_____	_____
<b>Total</b>	_____	_____
<b>II. Investments outside India in</b>		
(i) Government securities (Including local authorities)		
(ii) Subsidiaries and/or joint ventures abroad		
(iii) Other investments (to be specified)	_____	_____
<b>Total</b>	_____	_____
<b>Grand Total :(I &amp; II)</b>	_____	_____
<b>Schedule 9 - Advances</b>		
	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
<b>A.</b>		
(i) Bills purchased and discounted		
(ii) Cash credits, overdrafts and loans payable on demand		
(iii) Term loans	_____	_____
<b>Total</b>	_____	_____
<b>B.</b>		
(i) Secured by tangible assets		
(ii) Covered by Bank/Government Guarantees		
(iii) Unsecured	_____	_____
<b>Total</b>	_____	_____
<b>C. I. Advances in India</b>		
(i) Priority Sectors		
(ii) Public Sector		
(iii) Banks		
(iv) Others	_____	_____
<b>Total</b>	_____	_____



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### II. Advances outside India

(i) Due from banks		
(ii) Due from others		
(a) Bills purchased and discounted		
(b) Syndicated loans		
(c) Others	_____	_____
<b>Total</b>	_____	_____
<b>Grand Total : (C. I &amp; II)</b>	_____	_____

### Schedule 10 - Fixed Assets

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
<b>I. Premises</b>		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date		
<b>II. Other Fixed articles (including Furniture and Fixtures)</b>		
At cost as on 31st March of the preceding year		
Additions during the year		
Deductions during the year		
Depreciation to date	_____	_____
<b>Total : (I &amp; II)</b>	_____	_____

### Schedule 11 - Other Assets

	As on 31.3.... (Current year)	As on 31.3.... (Previous year)
<b>I. Inter-office adjustments (net)</b>		
<b>II. Interest accrued</b>		
<b>III. Tax paid in advance/tax deducted at source</b>		
<b>IV. Stationery and stamps</b>		



## Financial Statements of Banking Companies

V. Non-banking assets acquired in satisfaction of claims	_____	_____
VI. Others*	_____	_____
<b>Total</b>	_____	_____

\*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	_____	_____
<b>Total</b>	_____	_____

### Form 'B' Form of Profit & Loss Account for the year ended 31st March

	Schedule No.	Year ended As on 31.3.... (Current year)	('000 omitted) Year ended As on 31.3.... (Previous year)
I. <b>Income</b>			
Interest earned	13		
Other income	14	_____	_____
<b>Total</b>		_____	_____



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<b>II. Expenditure</b>			
Interest expended	15		
Operating expenses	16		
Provisions and contingencies		_____	_____
<b>Total</b>		_____	_____
<b>III. Profit/Loss</b>			
Net profit/loss (—) for the year			
Profit/Loss (—) brought forward		_____	_____
<b>Total</b>		_____	_____
<b>IV. Appropriations</b>			
Transfer to statutory reserves			
Transfer to other reserves			
Transfer to Government/Proposed dividends			
Balance carried over to balance sheet		_____	_____
<b>Total</b>		_____	_____

### 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	_____	_____
<b>Total</b>	_____	_____



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### 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		
<i>Less</i> : Loss on sale of investments		
III. Profit on revaluation of investments		
<i>Less</i> : Loss on revaluation of investments		
IV. Profit on sale of land, building and other assets		
<i>Less</i> : Loss on sale of land, building and other assets		
V. Profit on exchange transactions		
<i>Less</i> : 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	_____	_____
<b>Total</b>	_____	_____

*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	_____	_____
<b>Total</b>	_____	_____



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### 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 auditors)		
VIII. Law Charges		
IX. Postages, Telegrams, Telephones, etc.		
X. Repair and maintenance		
XI. Insurance		
XII. Other expenditure	_____	_____
<b>Total</b>	_____	_____

### Schedule 17 - Notes on Accounts

1. Reconciliation and consequential adjustments of pending items in inter-branch transactions including drafts payable and drafts paid without advice, accounts with other banks including foreign banks, clearing accounts and items in Sundries Receivable. Sundry Deposit Accounts are in progress. In some of the branches, balance in some of the accounts have not been tallied with those of subsidiary Ledger and Registers. Steps have already been taken to reconcile the differences. The effect of reconciliation of these pending items on the Profit & Loss Account and the Balance Sheet is not ascertainable at this stage.

2. In respect of un-audited branches, wherever information in regard to classification of advances were inadequate, the same has been classified to the extent possible on the basis of information available at the Administrative Offices/Head Office.

3. Advances due from sick units under nursing programmes, nationalised units, and in



## Financial Statements of Banking Companies

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respect of various sticky, suit filed and decreed accounts have been considered good on the basis of -

- (a) Available estimated value of existing and prospective primary and collateral securities including personal worth of the borrowers and the guarantors.
- (b) The proposed/on-going revival/rehabilitation programmes.
- (c) Pending settlement of claims by Government.
- (d) The claims lodged/to be lodged under various credit guarantee schemes and the Agriculture and Rural Debt Relief Scheme, 1990.

4. The excess of the book value over market value of investments in Indian Government securities as on 31st March, 2005 amounts to Rs.----- lakhs.

5. Premises include properties, book value of which is Rs. ----- lakhs, for which registration formalities are in progress.

6. The excess of liabilities over the readily realisable assets taken over from the erstwhile Bank of Thanjavur Limited is included under "Other Assets" pending settlement of claims lodged with Deposit Insurance and Credit Guarantee Corporation of India, realisation of assets taken over on collection basis and final settlement under the Scheme of Amalgamation.

7. The previous year's figures have been regrouped wherever practicable in accordance with the current year's classification as per the amended forms set out in Third Schedule to the Banking Regulation Act except in respect of classification of advances on securities/sectoral basis for which the information furnished by the Administrative Offices have been adopted.

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 denominator 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  
Tier II capital

This item should be shown by way of explanatory notes/remarks in the balance sheet as well as in 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

These provisions along with other provisions and



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## Financial Statements of Banking Companies

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NPA, toward depreciation in the value of investments and the provisions towards tax during the year	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	



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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

### Schedule 18 - 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. *Foreign Exchange Transactions* - (a) Monetary and non-monetary assets and liabilities have been translated at the exchange rates prevailing at the close of year.  
(b) Income and expenditure items in respect of Indian branches have been translated at the exchange rates ruling on the date of transactions and in respect of foreign branches at the exchange rates prevailing at the close of the respective half years.  
(c) Profit or loss on foreign currency position including pending forward exchange contracts has been accounted for at the exchange rates prevailing at the close of the year, as per the guidelines of the Foreign Exchange Dealers' Association of India.
3. *Investments* - Investments are shown at their book value.
4. *Advances* - Advances due from sick units under nursing programmes, nationalised units and in respect of various sticky, suit filed and decreed accounts have been considered good on the basis of :
  - (a) Available estimated value of existing and prospective primary and collateral securities including personal worth of the borrowers and guarantors.
  - (b) The proposed/on going revival/rehabilitation programmes.
  - (c) Pending settlement of claims by Government.
  - (d) The claim lodged/to be lodged under various credit guarantee schemes, and the Agriculture and Rural Debt Relief Scheme, 1990.



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## Financial Statements of Banking Companies

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- (e) Provisions to the satisfaction of auditors in respect of doubtful advances have been made and deducted from advances. Such provisions have been made on gross basis. Tax relief available when the advance is written off will be accounted for in the year of write off.
5. *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 prescribed in the Income Tax Rules, 1962 for Indian Assets. Depreciation in respect of Assets of Foreign branches has been provided as per the local laws.
6. *Staff Benefits* - Gratuity determined on actuarial basis has been paid to the approved gratuity fund constituted by the Bank.

### 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. Hindi version of the balance sheet will be part of the annual report.

#### 2.10 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**

<i>Item</i>	<i>Schedule</i>	<i>Coverage</i>	<i>Notes and instructions for compilation</i>
Capital	1	<p><b>Nationalised Banks Capital</b> (Fully Owned by Central Government)</p> <p>Banking companies incorporated outside India</p> <p><b>Other Banks (Indian)</b> 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.....</p>	<p>The capital owned by Central Government as on the date of the Balance Sheet including contribution from Government, if any, for participating in World Bank Projects should</p> <p>(i) The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head.</p> <p>(ii) The amount of deposit kept with RBI, under sub-section 2 of section 11 of the Banking Regulation Act, 1949 should also be shown. 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 the 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'.</p>
Reserves and Surplus	2	<p><b>(I) Statutory Reserves</b></p> <p><b>(II) Capital Reserves</b></p>	<p><b>Notes - General</b></p> <p>The changes in the above items, if any, during the years, say, fresh contribution made by Government, fresh issue of capital, capitalisation of reserves, etc. may be explained in the notes.</p> <p>Reserves created in terms of Section 17 or any other section of Banking Regulation Act must be separately disclosed.</p> <p>The expression 'capital reserves' shall not include any amount regarded as free for contribution through the profit and loss account. Surplus on revaluation should be treated as Capital Reserve Surplus on translation of the final instalment of foreign branches (which includes fixed assets also) is not a revaluation reserve.</p>



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## Financial Statements of Banking Companies

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		<b>(III) Share Premium</b>	Premium on issue of share capital may be shown separately under this head.
		<b>(IV) Revenue and other Reserves</b>	The expression 'Revenue Reserve', called any reserve other than capital reserve 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 fund for known liability.
		<b>(V) Balance of Profit</b>	Includes balance of profit after appropriations. In case of loss the balance may be shown as a deduction.
			<b>Notes – General</b>
			Movement in various categories of Reserves should be shown as indicated in the schedule
Deposits	3	<b>A. (I) Demand Deposits</b>	Includes all bank deposit repayable on demand. Includes all demand deposits of the non-bank sectors. Credit balances in overdrafts, 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.
		(i) from banks	
		(ii) from others	
		<b>(II) Saving Bank Deposits</b>	Includes all savings bank deposits (including inoperative savings bank accounts)
		<b>(III) Term Deposits</b>	Includes all types of bank deposits repayable after a specified term.
		(i) from banks	
		(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>B.</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**

(j) The total of I & II will agree with the total borrowings shown in the balance sheet.



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			<p>(ii) Inter-office transactions should not be shown as borrowings.</p> <p>(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.</p> <p>(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</p>
Other liabilities and provisions	5	<p>I. Bills payable</p> <p>II. Inter-office adjustment (net)</p> <p>III. Interest accrued</p> <p>IV. Others (including provisions)</p>	<p>Includes drafts, telegraphic transfers, travelers' cheques, mail transfers payable, pay slips, bankers cheques and other miscellaneous items.</p> <p>The inter-office adjustments balance, if in credit, should be shown under this head. Only net position of inter-office accounts,</p> <p>Includes interest accrued but not due on deposits and borrowings.</p> <p>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.</p>

### Notes – General

(j) For arriving at the net balance of inter-





Cash and Balances with the Reserve Bank of India	6	<p>I. Cash in hand (including foreign currency notes)</p> <p>II. Balances with Reserve Bank of India</p> <p>(i) in Current Account</p> <p>(ii) in other Accounts</p>	<p>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.</p> <p>(ii) The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability.</p> <p>(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)'.</p>
Balances with banks and money at call and short notice	7	<p>I. <b>In India</b></p> <p>(i) Balances with banks</p> <p>(a) in current accounts</p> <p>(b) in other Deposit accounts</p> <p>(ii) Money at call and short notice</p> <p>(a) with banks</p> <p>(b) with other institutions</p> <p>II. <b>Outside India</b></p> <p>(i) Current accounts</p> <p>(ii) Deposits accounts</p>	<p>Includes cash in hand including foreign currency notes and also of foreign branches in case of banks having such branches.</p> <p>Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposits accounts should be shown separately.</p> <p>Includes deposits repayable within 15 days or less than 15 days notice lent in the inter-bank call money market.</p> <p>Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balance 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 amount held in 'current accounts' and 'deposit accounts' should be shown separately.</p>



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		(iii) Money at call and short notice	Includes deposits usually classified in foreign countries as money at call and short notice.
Investments	8	<b>I. Investments in India</b>	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.
		(i) Government securities	
		(ii) Other approved securities	Securities other than Government securities, which according to the Banking Regulation Act, 1949 are treated as approved securities, should be included here.
		(iii) Shares	Investments in shares of companies and corporations not included in item (i) should be included here.
		(iv) Debentures and Bonds/companies	Investments in debentures and bonds of and corporations not included in item (i) should be included here.
		(v) Investment in subsidiaries/joint ventures	Investment 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.
		<b>II. Investments outside India</b>	
		(i) Government securities (including local authorities)	All foreign Government securities including securities issued by local authorities may be
		(ii) Subsidiaries and/ or joint ventures abroad	All investments made in the share capital of subsidiaries floated outside India and/or joint ventures abroad should be classified under this head.
		(iii) Others	All other investments outside India may be shown under this head.
Advances	9	<b>A.</b>	
		(i) Bills purchased and discounted	In classification under section 'A'. All out standings in India as well as outside less bad debt, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.
		(ii) Cash credits, over-drafts and loans repayable on demand	



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	(iii) Term loans	Including overdue instalments.
B.	(i) Secured by tangible assets	All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India
	(ii) Covered by Bank/ Government Guarantee	Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC & ECGC are to be included.
	(iii) Unsecured	All advances not classified under (i) and (ii) will be included here.
C.	<b>I. Advances in India</b>	Total of 'A' should tally with the total of 'B'. Advances should be broadly classified into 'Advances in India, and 'Advances outside India'. Advances in India will be further classified on the sectoral basis as indicated. Advances on sectors which for the time being
	(i) Priority sectors	
	(ii) Public sector	
	(iii) Banks	
	(iv) Others	
	<b>II. Advances outside India</b>	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>i.e.</i> , advances to public sector. Advances to Central and State
	(i) Due from banks	
	(ii) Due from others	
	(a) Bills purchased and discounted	Governments and other Government undertaking including Government companies and corporations which are, according to the status, to be treated as public sector companies are to be included in the category "Public Sector".
	(b) Syndicate loans	
(c) Others	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.	
	<b>Notes – General</b>	
	(i) The gross amount of advances including refinance and rediscounts but excluding provisions made to the satisfaction	



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## Financial Statements of Banking Companies

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			of auditors should be shown as advances. (ii) Term loans will be loans not repayable (iii) Consortium advances would be shown
Fixed Assets	10	<b>I. Premises</b> (i) At cost as on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year there from (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 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.
		<b>II. Other Fixed Assets</b> (including furniture and fixtures) (i) At cost on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year	Motor vehicles and other fixed assets other than premises but including furniture should be shown under this head.
Other Assets	11	<b>III. Depreciation to date</b> <b>I. Inter/office adjustments (net)</b>	The inter-office adjustments balance, if indebit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balance of inter-office 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.
		<b>II. Interest accrued</b>	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 borrowings' 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 in 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 stationary 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. 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.
Contingent Liabilities	12	I. Claims against the bank not acknowledged as debts	
		II. Liability for partly paid investments	Liabilities on partly paid shares, debentures, etc. will be included under this head.
		III. Liability on account of outstanding forward	Outstanding forward exchange contracts may be included here.



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		exchange contracts	
		<b>IV. Guarantees given on behalf of constituents</b>	Guarantees given for constituents in India and outside India may be shown separately.
		(i) In India	
		(ii) Outside India	
		<b>V. Acceptances endorsements and other obligations</b>	This item will include letters of credit and bills accepted by the bank on behalf of customers.
		<b>VI. Other items for which the Bank is contingently liable</b>	Arrears of cumulative dividends, bills rediscounted under underwriting contracts,
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.
<b>Profit and Loss Account</b>			
Interest earned	13	<b>I. Interest/discount on advances/bills</b>	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.
		<b>II. Income on Investments</b>	Includes all income derived from the investment portfolio by way of interest and dividend
		<b>III. Interest on balances with Reserve Bank of India and other Interbank funds</b>	Includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
		<b>IV. Others</b>	Includes any other interest/discount income not included in above heads.
Other Income	14	<b>I. Commission, exchange and brokerage</b>	Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers,



	commission on letter of credit, letting out of lockers and guarantees, commission on Government business commission on other permitted agency business including consultancy and other services, broke-rage, etc. on securities. It does not include foreign exchange income.
<b>II. Profit on sale of investments Less Loss on sale of investments etc.</b>	Includes profit/loss on sale of securities, furniture land and buildings, motor of vehicle, gold, silver. Only the net position should be shown. If the net position is a loss, the amount should be deduction.
<b>III. Profit on revaluation of investments Less: Loss on revaluation of investments</b>	The net profit/loss on revaluation of assets may also be shown under this item.
<b>IV. Profit on sale of land, building and other assets Less : Loss on sale of land, buildings and other assets</b>	
<b>V. Profit on exchange transactions Less : Loss on exchange transactions</b>	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.
<b>VI. Income earned by way of dividends etc. from subsidiaries, companies, joint ventures abroad/in India</b>	
<b>VII. Miscellaneous income</b>	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



## Financial Statements of Banking Companies

			income, particulars may be given in the notes.
Interest	15	<b>I. Interest on deposits</b>	Includes interest paid on all types of deposits including deposits from banks and others institutions.
		<b>II. Interest on Reserve Bank of India/inter-bank borrowings</b>	Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.
		<b>III. Others</b>	Includes discount / interest on all borrowings/refinance from financial institutions. All other payments like interest on participation certificates, penal interest paid, etc. may also be included here.
Operating expenses	16	<b>I. Payments to and Provisions for employees</b>	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.
		<b>II. Rent, taxes and lighting</b>	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'.
		<b>III. Printing and Stationery</b>	Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.
		<b>IV. Advertisement and publicity</b>	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.
		<b>V. Depreciation on Bank's property</b>	Includes depreciation on bank's own property: motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non banking assets, etc.





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<b>VI. Directors' allowances and expenses</b>	fees, and	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. Similary expenses of local Committee members may also be included under this head.
<b>VII. Auditors' fees and expenses (including branch auditors' fees and expenses)</b>	fees	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'.
<b>VIII. Law charges</b>		All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
<b>IX. Postage, telegrams, telephones, etc.</b>		Includes all postal charges like stamps, tele-gram, telephones, teleprinter, etc.
<b>X. Repairs and maintenance</b>		Includes repairs to banks' property, their maintenance charges, etc..
<b>XI. Insurance</b>		Includes insurance charges on bank's property, insurance premia paid to Deposit Insurance & Credit Guarantee Corporation, etc. to the extent they are not recovered from the concerned parties.
<b>XII. Other expenditure</b>		All expenses other than those not included in any of the other heads like, licence fees, donations,



## Financial Statements of Banking Companies

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Provisions and contingencies	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. 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.
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### 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



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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.



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## Financial Statements of Banking Companies

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(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**

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 as 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



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## Financial Statements of Banking Companies

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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.



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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



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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 (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.)	0
➤ 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 superannuation benefits and mortgage of flat / house. (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.)	20
➤ 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



## Financial Statements of Banking Companies

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 :

- In the case of loans and advances, the following amounts are deducted :
  - The amount of cash margin or deposit made against the advances as a collateral.
  - The amount of provision for bad and doubtful debts. (Similarly, in the case of other assets, e.g., investments, provision for depreciation are deducted.)
  - Credit balances in the current or other accounts of the borrower which are not earmarked for specific purpose and are free from any lien.
- 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.
- The all-India financial institutions whose bonds/debentures would qualify for 20 per cent risk weight for capital adequacy ratio are as the following.



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- (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.



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<i>Off-balance sheet items</i>	<i>Credit conversion factor (per cent)</i>	<i>Risk weight (per cent)</i>
◆ 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 / State Government	100	0
➤ 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 / State Government	50	0
➤ 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		



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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 the Governments	50	0
➤ 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 cancelled at any time	0	0
◆ Aggregate outstanding foreign exchange contracts of original maturity –		



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➤ up to 14 calendar days	2	0
➤ more than 15 calendar days but less than one year	2	100
➤ 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





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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.



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### 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
<b>1. Cash &amp; bank balances</b>			
(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)			
<b>II. Money at call and short notice</b>		0	0
<b>III. Investments</b>			
(a) Government and other approved securities*		0	0
(b) Others (net of depreciation provided)		100	
<b>IV. Advances**</b>			
Loans and advances, bills purchased and discounted and other credit facilities			
(a) Claims guaranteed by		0	0



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Government of India		
(b) Claims guaranteed by State Governments	0	0
(c) Claims on public sector undertakings of Governments	100	
(d) Others	100	
<b>Note:</b> 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.



## Financial Statements of Banking Companies

### 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

(i) Capital Funds - Tier I :	<i>Rs. in lakhs</i>	<i>Rs. in lakhs</i>
Equity Share Capital		480,00
Statutory Reserve		280,00
Capital Reserve (arising out of sale of assets)		<u>9,30</u>
		769,30



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### Capital Funds - Tier II :

Capital Reserve (arising out of revaluation of assets)	280	
Less : Discount to the extent of 55%	<u>154</u>	<u>1,26</u>
		<u>770,56</u>

### (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	<u>2,01,20</u>
			63,68,20
<i>Off-Balance Sheet Item</i>	<i>Rs. in Lakhs</i>	<i>Credit Conversion Factor</i>	
Acceptances, Endorsements and Letters of credit	37,02,50	100	<u>37,02,50</u>
			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.



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## Financial Statements of Banking Companies

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### 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 satisfied:





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- (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 as 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,



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## Financial Statements of Banking Companies

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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.



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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

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\* 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 institution') 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 institution. 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 institution. For a take-out finance arrangement to take effect, the borrower should also recognise the arrangement by way of inter-creditor arrangement.



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## Financial Statements of Banking Companies

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norms in the usual manner so long as the account remains on its books.

### *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, 2006.

**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) = <u>170</u>
	<u>1,057</u>

**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.



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## Financial Statements of Banking Companies

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- (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 classify 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



## Financial Statements of Banking Companies

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





## Advanced Accounting

**Illustration 2** (Existing stock of advances classified as 'doubtful more than 3 years' as on 31 March, 2004.)

The outstanding amount as on 31<sup>st</sup> March, 2004: Rs.25,000.

Realisable value of security: Rs.20,000.

Period for which the advance has remained in 'doubtful' category as on 31<sup>st</sup> 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, 2004.)

The outstanding amount (funded as well as unfunded) as on 31<sup>st</sup> March, 2004: Rs.10,000

Realisable value of security: Rs.8,000

Period for which the advance has remained in 'doubtful' category as on 31<sup>st</sup> March, 2004: 2.5 years.

**Solution:**

**Provisioning requirement:**

As on...	Asset Classification	Provisions on secured portion		Provisions on unsecured portion		Total (Rs.)
		%	Amount	%	Amount	
31 March, 2004	Doubtful 1 to 3 years	30	2,400	100	2,000	4,400
31 March, 2005	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, 2005,



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## Financial Statements of Banking Companies

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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 loan 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, 2004)



## Financial Statements of Banking Companies

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, 2006) Rs.1.125 lakhs (@ 75% of the secured portion)

Total provision to be made Rs.2.15 lakhs (as on March 31, 2006)

### 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

	<i>Term Loan</i>	<i>Export Loan</i>
Balance Outstanding on 31.03.2006	Rs. 35 lakhs	Rs. 30 lakhs
<i>DICGC/ECGC cover</i>	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

	<i>Term loan Rs. in lakhs</i>	<i>Export credit Rs. in lakhs</i>
Balance outstanding on 31.3.2006	35.0	30.0
Less: Realisable value of Securities	<u>10.0</u>	<u>8.0</u>
	25.0	22.0
Less: DICGC cover @ 40%	10.0	



## Advanced Accounting

ECGC cover @ 50%	---	<u>11.0</u>
Unsecured balance	<u>15.0</u>	<u>11.0</u>
Required Provision:		
100% for unsecured portion	15.00	11.00
Add: 100%* for secured portion	<u>10.00</u>	<u>8.00</u>
Total provision required	<u>25.00</u>	<u>19.00</u>

### 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
<i>Assets</i>	
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

<i>Assets</i>	<i>Amount</i>	<i>% of provision</i>	<i>Provision</i>
	<i>Rs. in lakhs</i>		<i>Rs. in lakhs</i>
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	<u>1,000</u>

\* 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.



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1,960

### 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:

<i>Assets</i>	<i>Amount</i> <i>(Rs. in lakhs)</i>	<i>% of Provision</i>	<i>Provision</i> <i>(Rs. in lakhs)</i>
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	<u>500</u>
			<u>1,316</u>

\*\* 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

\* It is assumed that the advance has been classified as doubtful for more than 3 years or on or after 1.4.2004.



(predominantly government securities) and other securities (shares, debentures, bonds etc.). Banks are required to classify their entire investment portfolio into three categories : held-to-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



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## Financial Statements of Banking Companies

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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:

#### *1. 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?





## Advanced Accounting

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- (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



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## Financial Statements of Banking Companies

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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 1.4.2005 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 10.6.05
B	12,00,000	Party paid off on 30.9.05
C	5,00,000	Party failed to pay and bank had to honour on 30.11.05



## Advanced Accounting

D	8,00,000	Not satisfied upto 31.3.06
E	5,00,000	-do-
F	<u>2,70,000</u>	-do-
Total	<u>42,70,000</u>	

### Solution

#### Acceptances, Endorsements and other Obligation Account (in general ledger)

<i>Dr.</i>	<i>Rs. '000</i>	<i>Cr.</i>	<i>Rs. '000</i>
2005-06 To Constituents' liabilities for acceptances/guarantees etc. (Paid off by clients)	20,00	1.4.05 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	2005-06 By Constituents' liabilities for acceptances/guarantees etc.	
		A	10,00
		B	12,00
		C	5,00
10.6.05 To Constituents' liabilities for acceptances/guarantees etc. (Honoured by bank)	10,00	D	8,00
		E	5,00
30.9.05 To Constituents' liabilities for acceptances/guarantees etc. (Paid off by party)	12,00	F	<u>2,70</u>
30.11.05 To Constituent's liabilities for acceptances/guarantees etc. (Honoured by bank on party's failure to pay)	5,00		42,70
31.3.06 To Balance c/d (Acceptances not yet satisfied)	<u>15,70</u>		
	<u>65,00</u>		<u>65,00</u>



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### Illustration 1

The following is an extract from Trial Balance of overseas Bank Ltd. as at 31st March, 2006

	<i>Rs.</i>	<i>Rs.</i>
Bills discounted	12,64,000	
Rebate on bills discounted not due on March 31st, 2005		22,160
Discount received		1,05,708

An analysis of the bills discounted is as follows:

	<i>Amount</i>	<i>Due Date 2006</i>	<i>Rate of Discount</i>
	<i>Rs.</i>		<i>(%)</i>
(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 31-3-2006 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  
$$14/100 \times 66/365 \times \text{Rs. } 1,40,000 = \text{Rs. } 3,544.$$
- (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.



## Advanced Accounting

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The amount of discount to be credited to the Profit and Loss Account will be:

	<i>Rs.</i>
Transfer from Rebate on bills discount as on 31-3-2005	22,160
<i>Add:</i> Discount received during the year ended 31-3-2006	<u>1,05,708</u>
	1,27,868
<i>Less:</i> Rebate on bills discounted as on 31.3.2006 (see above)	<u>42,317</u>
	<u>85,551</u>

The journal entries will be as follows :

	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
Rebate on Bills Discounted A/c	Dr.	
To Discount on Bills A/c	22,160	
(Being the transfer of Rebate on Bills Discounted on 31-3-2005 to Discount on Bills Account)		22,160
<hr/>		
Discount on Bills A/c	Dr.	
To Rebate on Bills Discounted A/c	42,317	
(Being the transfer of rebate on bills discounted required on 31-3-2001 from discount on Bills Account)		42,317
<hr/>		
Discount on Bills A/c	Dr.	
To Profit and Loss A/c	85,551	
(Being the amount of discount on Bills transferred to Profit and Loss Account)		85,551

**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 is 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.





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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 2

On 31st March, 2005, Uncertain Bank Ltd. had a balance of Rs. 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 2006, 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, 2006, the average period outstanding after 31st March, 2006 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

		<i>(Rupees in crores)</i>	
		<i>Dr.</i>	<i>Cr.</i>
		<i>Rs.</i>	<i>Rs.</i>
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)			
<hr/>			
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)			
<hr/>			



## Financial Statements of Banking Companies

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			
2006		Rs.	2005		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	2005-06	By Bills purchased and discounted A/c	144.00
		<u>153.00</u>			<u>153.00</u>

(ii)		Rebate on bills discounted A/c			
2005		Rs.	2005		Rs.
April 1	To Discount on bills A/c	9.00	April 1	By Balance b/d	9.00
2006			2006		
March 31	To Balance c/d	<u>10.80</u>	March 31	By Discount on bills A/c	<u>10.80</u>
		<u>19.80</u>			<u>19.80</u>

### Illustration 3

Following facts have been taken out from the records of Adarsha Bank Ltd. in respect of the year ending March 31, 2005 :

- (a) On 1-4-2004 Bills for collection were Rs. 7,00,000. During 2004-2005 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.



## Advanced Accounting

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- (b) On 1-4-2004, 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 Obligations A/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 30-9-2005 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31-3-2006 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., 2005). But due to fluctuations, the price fell to Rs. 40 per share in January, 2006. On 31-3-2006, 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 31-3-2006 :

	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
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 2005-2006 amount to Rs. 14,000. Prepare Ledger Accounts.

### Solution

(a)		Bills for Collection (Assets) A/c		
		<i>Rs.</i>		<i>Rs.</i>
2004			2004-05	
Apr. 1	To Balance b/d	7,00,000	By Bills for	
2004-05			Collection (Liabilities) A/c	47,00,000
	To Bills for Collection		By Bills for collection	
	(liabilities) A/c	64,50,000	(Liabilities) A/c	5,50,500
			2005	
			Mar. 31 By Balance c/d	<u>18,99,500</u>
		<u>71,50,000</u>		<u>71,50,000</u>



**Financial Statements of Banking Companies**

**Bills for Collection (Liabilities) A/c**

	<i>Rs.</i>	<i>2004</i>	<i>Rs.</i>
2004-05 To Bills for collection (Assets) A/c	47,00,000	Apr. 1	By Balance b/d 2004-05
To Bills for Collection (Assets) A/c	5,50,500	By Bills for collection (Assets) A/c	7,00,000 64,50,000
2005 Mar. 31 To Balance c/d	<u>18,99,500</u>		
	<u>71,50,000</u>		<u>71,50,000</u>

(b) **Acceptances, Endorsement & other Obligation A/c**

<i>2004-05</i>	<i>Rs.</i>	<i>2004</i>	<i>Rs.</i>
To constituents' Liability for Acceptance, Endorsement, etc.	25,00,000	Apr. 1	By Balance b/d 2004-05
To Constituents' Liability for Acceptances, Endorsement etc.	10,00,000	By constituents, Liabilities for Acceptances, Endorsements, etc.	14,50,000 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	<u>22,50,000</u>		
	<u>58,50,000</u>		<u>58,50,000</u>

(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**

	<i>Rs.</i>		<i>Rs.</i>
2005-06 To Interest and Discount A/c	6,000	2005 Apr. 1	By Balance b/d
2006 Mar. 31 To Balance c/d	<u>14,000</u>		20,000
	<u>20,000</u>		<u>20,000</u>



Interest & Discount Account			
2006	Rs.	2005	Rs.
Mar. 31 To Profit & Loss A/c	98,06,000	Apr. 1 By Balance b/d	98,00,000
		2005-06 By Rebate on Bills	
		discounted A/c	<u>6,000</u>
	<u>98,06,000</u>		<u>98,06,000</u>

#### 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 is present at 5 per cent in the year 2006.

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



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## Financial Statements of Banking Companies

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CRR maintained by commercial banks on total Demand and Time Liabilities should not be less than 3 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 outstanding 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

#### *1. 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.



## Advanced Accounting

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- (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:

<i>Bills discounted due date of which is beyond 31st March, 2006</i>	<i>Due Date</i>	<i>Rate of Discount</i>
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, 2006 giving the relevant schedules and also specify at least four important Principal Accounting Policies :

	<i>Rs. in lakhs</i>	
	Dr.	Cr.
Share Capital 19,80,000 Shares of Rs. 10 each		198.00
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	





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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	<u>792.88</u>	
	<u>2,588.22</u>	<u>2,588.22</u>

### 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, 2006

(Rs. in lacs)

Capital and Liabilities	Schedule	As on 31.3.06	As on 31.3.05
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	<u>0.10</u>	
		<u>25,88.22</u>	



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## Financial Statements of Banking Companies

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### 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	<u>—</u>
		<u>25,88.22</u>
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	<u>1,98.00</u>

### Schedule 2— Reserves and Surplus

(1) Statutory Reserve-		
Opening balance	2,31.00	
Additions during the year	<u>30.00</u>	
		2,61.00
(2) Balance in Profit & Loss Account ( <i>W.N. 1</i> )		<u>5,32.00</u>
		<u>7,93.00</u>

### Schedule 3— Deposits

(i) Demand deposits from others	5,20.12
(ii) Saving bank deposits	4,50.00
(iii) Fixed Deposits	<u>5,17.00</u>
	<u>14,87.12</u>



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### Schedule 4— Borrowings

Borrowing in India-	
Other banks	<u>1,10.00</u>

### Schedule 5— Other Liabilities and Provisions

Other liabilities and provisions	<u>0.10</u>
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### Schedule 6— Cash and balances with RBI

(i) Cash in hand	1,60.15
(ii) Balances with RBI	
In current account ( <i>W.N. 2</i> )	<u>44.61</u>
	<u>2,04.76</u>

### Schedule 7—Balances with banks and money at call and short notice

1. In India	
(i) Balances with banks	
(a) in current accounts ( <i>W.N. 3</i> )	1,49.14
(ii) Money at call and short notice	<u>2,10.12</u>
	<u>3,59.26</u>

### Schedule 8— Investments

(1) Investment in India in	
(i) Government securities	1,10.17
(ii) Others—Gold	<u>55.23</u>
	<u>1,65.40</u>

### Schedule 9— Advances

A. (i) Cash credits, overdrafts	8,40.10
(ii) Term Loans	<u>7,92.88</u>
	<u>16,32.98</u>



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## Financial Statements of Banking Companies

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B (i) Secured by tangible assets	11,52.53
(ii) Secured by bank/government guarantees	3,96.44
(iii) Unsecured	<u>84.01</u>
	<u>16,32.98</u>

### Schedule 10— Fixed Assets

1. Premises	
At cost on 31st March, 1994	156.80
Depreciation to date	<u>1.10</u>
	<u>155.70</u>
2. Other Fixed Assets	
Furniture at cost on 31st March, 1994	70.90
Depreciation to date	<u>0.78</u>
	<u>70.12</u>
Total (1 + 2)	<u>2,25.82</u>

### Schedule 11— Other Assets

Nil

### Schedule 12— Contingent Liabilities

(i) Claims against bank not acknowledged as debts	0.55
(ii) Acceptances, endorsements	<u>14.12</u>
	<u>14.67</u>

### 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)	<u>4,46.14</u>



## Advanced Accounting

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### Working Note :

(1) Balance in Profit & Loss Account :	
Net Profit before appropriation	1,50.00
<i>Add</i> : Profit for the year	<u>4,12.00</u>
	5,62.00
<i>Less</i> : Transfer to statutory reserve	
(20% of 1,50.000)	<u>30.00</u>
	<u>532.00</u>
(2) Transfer from Cash with other banks to Cash with RBI	
Cash reserve required	44.61
Cash with RBI	<u>37.88</u>
Transfer needed to maintain cash reserve	<u>6.73</u>
(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	<u>1,10.17</u>
	<u>6,91.54</u>
Excess liquidity (6,91.54 – 4,46.14)	<u>2,45.40</u>

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



## Financial Statements of Banking Companies

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 31-3-2006 :

<i>'000 Rs.</i>	<i>Item</i>	<i>'000 Rs.</i>
2004-2005		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



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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 :

20% of profit is transferred to Statutory Reserves

5% of profit is transferred to Revenue Reserve.



## Financial Statements of Banking Companies

### Solution

#### Modern Bank Ltd.

#### Profit and Loss Account for the year ended 31-3-2006

		<i>(Rs. 000's)</i>	
	<i>Schedule</i>	<i>Year ended</i>	<i>Year Ended</i>
	<i>No.</i>	<i>31-3-2006</i>	<i>31-3-2005</i>
<b>I. Income</b>			
Interest Earned	13	26,41	16,96
Other Income	14	<u>8,22</u>	<u>7,34</u>
Total		<u>34,63</u>	<u>24,30</u>
<b>II. Expenditure</b>			
Interest Expended	15	9,69	7,39
Operating Expenses	16	20,96	16,97
Provisions and Contingencies		<u>2,95</u>	<u>—</u>
Total		<u>33,60</u>	<u>24,36</u>
<b>III. Profit/Loss</b>			
Net Profit/Loss (—) for the year		1,03	(6)
Profit/Loss (—) brought forward		<u>(6)</u>	<u>—</u>
Total		<u>97</u>	<u>(6)</u>
<b>IV. Appropriations</b>			
Transfer to Statutory Reserve		20.60	
Transfer to Other Reserve, Proposed Dividend		5.15	
Balance carried over to Balance Sheet		<u>71.25</u>	
Total		<u>97.00</u>	





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### Schedule 13 - Interest Earned

	<i>(Rs. 000's)</i>	
	<i>Year ended</i>	<i>Year Ended</i>
	<i>31-3-2006</i>	<i>31-3-2005</i>
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	<u>—</u>	<u>—</u>
Total	<u>26,41</u>	<u>16,96</u>

### Schedule 14 - Other Income

I. Commission, Exchange and Brokerage		7,12	7,22
II. Profit on Sale of Investments	1,22		
<i>Less: Loss on sale of Investments</i>	<u>12</u>	<u>1,10</u>	<u>12</u>
Total		<u>8,22</u>	<u>7,34</u>

### Schedule 15 - Interest Expended

I. Interest on Deposits		8,22	6,12
II. Interest on RBI/inter-bank borrowings		<u>1,47</u>	<u>1,27</u>
Total		<u>9,69</u>	<u>7,39</u>

### Schedule 16 - Operating Expenses

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			



### Financial Statements of Banking Companies

(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	<u>20,96</u>	<u>16,97</u>

#### Illustration 3

From the following information, prepare Profit and Loss A/c of Hyderabad Bank Ltd. for the year ended 31st March, 2006.

<i>Items</i>	<i>000 Rs.</i>
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



## Advanced Accounting

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### Other Information:

(i) Interest on NPA is as follows

	<i>Earned (Rs. '000)</i>	<i>Collected (Rs. '000)</i>
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 31-3-2006.

### Solution

#### Hyderabad Bank Ltd.

#### Profit and Loss Account

For the year ended 31st March, 2006

I	Income	Schedule	(Rs. '000) Year Ended 31-3-2001
	Interest earned	13	38,30
	Other income	14	<u>2,50</u>
			<u>40,80</u>
II	Expenditure		
	Interest expended	15	27,20
	Operating expenses	16	23,40
	Provisions and Contingencies		<u>621.5</u>
			<u>56,81.5</u>



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**Financial Statements of Banking Companies**

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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)	<u>10,40</u>	28,40
II Income on investments		8,40
III Interest on Balance with RBI		<u>1,50</u>
		<u>38,30</u>

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	<u>82</u>	2,75
IV Profit on sale of Land and Building		27
V Loss on Exchange Transactions		<u>(52)</u>
		<u>2,50</u>

**Schedule 15 - Interest Expended**

I Interest on Deposits	<u>27,20</u>
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**Schedule 16 - Operating Expenses**

I Payment and provision for employees		
Salaries, allowances and bonus	12,40	
Provident Fund Contribution	<u>2,80</u>	15,20



## Advanced Accounting

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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	<u>50</u>
		<u>23,40</u>

### 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%)	<u>2,00</u>
		534

#### *Depreciation on current investments*

Cost 25% of 27,50	687.50	
Less : Market value	<u>600.00</u>	<u>87.5</u>
		<u>621.5</u>

### Illustration 4

The following are the ledger balances (in Rupees thousands) extracted from the books of Vaishnavi Bank Limited as on March 31, 2006 :

	<i>Dr.</i>	<i>Cr.</i>
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	



## Financial Statements of Banking Companies

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	<u>2,00,00</u>	
	<u>79,10,00</u>	<u>79,10,00</u>



## Advanced Accounting

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### Other Information:

The bank's Profit and Loss Account for the year ended and Balance Sheet as on 31st March, 2006 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, 2006

		('000 Rs.)	
<i>Capital and Liabilities</i>	<i>Schedule</i>	<i>As on</i> <i>31-3-2006</i>	<i>As on</i> <i>31-3-2005</i>
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	<u>1,14,20</u>	
Total		<u>61,86,00</u>	
		('000 Rs.)	
<i>Assets</i>	<i>Schedule</i>	<i>As on</i> <i>31-3-2006</i>	<i>As on</i> <i>31-3-2005</i>
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	



## Financial Statements of Banking Companies

Fixed Assets	10	6,35,00
Other Assets	11	<u>4,46,20</u>
Total		<u>61,86,00</u>
Contingent liabilities	12	5,65,00
Bills for collection		4,35,00

### Vaishnavi Bank Ltd.

#### Profit and Loss Account for the year ended 31-3-2006

<b>I. Income</b>		
Interest & Discount	13	10,40,00
Other income	14	<u>98,00</u>
		<u>11,38,00</u>
<b>II. Expenditure</b>		
Interest Expended	15	79,50
Operating Expenses	16	4,59,50
Provisions and Contingencies		<u>40,00</u>
		<u>5,79,00</u>
<b>III. Profits/Loss</b>		
Net profit for the year		5,59,00
Profit b/f		<u>65,00</u>
		<u>6,24,00</u>
<b>IV. Appropriations</b>		
Transfer to Statutory Reserve		1,11,80
Balance carried over to Balance Sheet		<u>5,12,20</u>
		<u>6,24,00</u>

#### Schedule 1 - Capital

(Rs. '000)

As on 31-3-2006 As on 31-3-2005

<b>III. For Other Banks</b>	
Authorised Capital	
Shares of Rs. ... each	—





## Advanced Accounting

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Issued Capital	
Shares of Rs. ... each	–
Subscribed Capital	
Shares of Rs. ... each	–
Called up capital	
Shares of Rs. ... each	<u>19,00,00</u>
	<u>19,00,00</u>

### Schedule 2 - Reserves & Surplus

<b>I. Statutory Reserves</b>	
Opening Balance	14,00,00
Additions during the year	<u>1,11,80</u>
	15,11,80
<b>V. Balance in Profit and Loss Account</b>	<u>5,12,20</u>
Total	<u>20,24,00</u>

### Schedule 3 - Deposits

	<i>(Rs. '000)</i>	
	<i>As on</i>	<i>As on</i>
	<i>31-3-2006</i>	<i>31-3-2005</i>
<b>A. I. Demand Deposits</b>	9,95,00	
<b>II. Saving Bank Deposits</b>	1,50,00	
<b>III. Term Deposits</b>	<u>2,30,50</u>	
	<u>13,75,50</u>	

### Schedule 4 - Borrowings

<b>I. Borrowings in India</b>	
(ii) Other banks	<u>7,72,30</u>
Total	<u>7,72,30</u>



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## Financial Statements of Banking Companies

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### Schedule 5 - Other liabilities and provisions

#### IV. Other liabilities including provisions:

Rebate on bills discounted	40,00
Employees Security Deposit	<u>74,20</u>
Total	<u>1,14,20</u>

### 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



## Advanced Accounting

### Schedule 8 - Investments

		('000 Rs.)	
		<i>As on</i>	<i>As on</i>
		<i>31-3-2006</i>	<i>31-3-2005</i>
I. Investments in India in			
(i) Government securities		9,43,70	
(ii) Shares (assumed)		5,56,30	
(vi) Gold		1,51,30	
Silver		<u>20,00</u>	
Total		<u>16,71,30</u>	

### Schedule 9 - Advances

A. (i) Bills purchased and discounted		1,25,00	
(ii) Cash credits, overdrafts and loans repayable on demand		<u>18,35,00</u>	
		<u>19,60,00</u>	
B. (i) Secured by tangible assets		12,00,00	
(ii) Secured by Bank/Govt. Securities		2,00,00	
(iii) Unsecured		<u>5,60,00</u>	
		<u>19,60,00</u>	
C. I. Advances in India			
(i) Priority sector		8,00,00	
(ii) Public sector		1,00,00	
(iii) Banks		20,00	
(iv) Others		<u>10,40,00</u>	
Total		<u>19,60,00</u>	

(Details are assumed)

### Schedule 10 - Fixed Assets

I. Premises			
At cost as on 31st March, 2000	6,42,00		
Depreciation to date	<u>50,00</u>		
		5,92,00	
II. Other fixed articles (including Furniture and Fixture)			
At cost as on 31st March, 2000	48,00		
Depreciation to date	<u>5,00</u>		<u>43,00</u>
Total (I & II)			<u>6,35,00</u>



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**Financial Statements of Banking Companies**

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**Schedule 11 - Other Assets**

	<i>( '000 Rs.)</i>	
	<i>As on</i>	<i>As on</i>
	<i>31-3-2006</i>	<i>31-3-2005</i>
I. Inter-office adjustments (net)	2,00,00	
II. Interest accrued	<u>2,46,20</u>	
	<u>4,46,20</u>	

**Schedule 12 - Contingent Liabilities**

	<i>Year ended</i>	<i>Year ended</i>
	<i>31-3-2006</i>	<i>31-3-2005-</i>
V. Acceptances, endorsements and other obligations	<u>5,65,00</u>	
Total	<u>5,65,00</u>	

**Schedule 13 : Interest Earned**

I. Interest/discount on advances, bills	7,93,80
II. Income on Investments	<u>2,46,20</u>
Total	<u>10,40,00</u>

**Schedule 14 : Other Income**

I. Commission, Exchange and Brokerage	2,53,00
II. Profit on sale of investments	
<i>Less</i> : Loss on sale on investments	<u>2,00,00</u> 53,00
VII. Miscellaneous Income	
Rent and Other Receipts	<u>45,00</u>
Total	<u>98,00</u>

**Schedule 15 : Interest Expended**

I. Interest on Deposits	<u>79,50</u>
Total	<u>79,50</u>

**Schedule 16 : Operating Expenses**

I. Payments to and provisions for employees	2,12,00
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## Advanced Accounting

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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.	<u>12,50</u>
Total	<u>4,59,50</u>

### 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, 2006

	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



## Financial Statements of Banking Companies

### 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, 2006 :

	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



## Advanced Accounting

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3. From the following Trial Balance and other information prepare Final Accounts of Jay Bank Ltd. for the year ending 31st March, 2006 :

	<i>Dr.</i>	<i>Cr.</i>
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		<u>15,50,000</u>
	<u>1,29,18,000</u>	<u>1,29,18,000</u>

**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) 20% of the profit is to be transferred to statutory reserve and 5% to the revenue reserve.

# 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.



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## Financial Statements of Insurance Companies

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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 nationalisation 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 :

$$\text{Paid-up value} = \frac{\text{No. of premium paid} \times \text{Sum assured}}{\text{Total No. of premiums payable}}$$

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



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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 nor 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.



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- (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.



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- (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 not 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.





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- (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.



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*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



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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.



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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 First 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



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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) -



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- (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 respect 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 business, the required solvency margin shall be the higher of the following amounts :-  
(a) fifty crores of rupees (one hundred crores of rupees in case 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 -



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(A.1) there shall be taken, a sum equal to a percentage determined by the regulations not exceeding 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 :



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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 policy 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



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## Financial Statements of Insurance Companies

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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



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## Financial Statements of Insurance Companies

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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 :



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### *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.





**DIVISIONAL OFFICE**

**Statement Showing Summary of Outstanding Claims as at 31-12-2005**

		FIRE		MARINE		MOTOR		MISC.	
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	
<i>Amount of Claim (Category)</i>	<i>Total No.</i>	<i>To Check</i>		<i>To Check</i>		<i>To Check</i>		<i>To Check</i>	
		<i>No.</i>	<i>Amount (Rs.)</i>	<i>No.</i>	<i>Amount (Rs.)</i>	<i>No.</i>	<i>Amount (Rs.)</i>	<i>No.</i>	<i>Amount (Rs.)</i>

1. Rs. 3 lacs and above.
2. Above Rs. 1.00 lac but less than Rs. 3.00 lacs.
3. Above Rs. 25,000 but less than Rs. 1.00 lac.
4. Above Rs. 10,000 but less than Rs. 25,000.
5. Claims less than Rs. 10,000 each.

Claims Checked \_\_\_\_\_

	(10)	(11)	(12)	(13)
TOTAL PROVISION	Rs. _____	Rs. _____	Rs. _____	Rs. _____

Note: Fill up the aggregate amount for number of claims checked in each category.



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## Financial Statements of Insurance Companies

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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.

Refer to Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2000.

### 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



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Railway Ordinary Stocks (*l*) in India (*ii*) out of India

Other Debentures and Debenture Stock of Companies incorporated (*l*) in India (*ii*) out of India

Other Guaranteed and Preference Stocks and Shares of Companies incorporated (*l*) in India (*ii*) out of India

Other Ordinary Stocks and Shares of Companies incorporated (*l*) 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.

## **2.10 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.

## **2.11 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 or 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 contract. 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



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## Financial Statements of Insurance Companies

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- (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 consultation 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 30<sup>th</sup> 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:

<b>Schedule A for Life Insurance Business</b>	<b>Schedule B for General Insurance Business</b>
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.



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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

30<sup>th</sup> 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.





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(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



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## Financial Statements of Insurance Companies

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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



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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



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## Financial Statements of Insurance Companies

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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.



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## Financial Statements of Insurance Companies

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- 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. (l) For the purposes of financial statements, unless the context otherwise requires -



## Advanced Accounting

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- (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;



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## Financial Statements of Insurance Companies

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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.



**Financial Statements of Insurance Companies**

**FORM A-RA**

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31<sup>ST</sup> MARCH, 20\_\_.

Policyholders' Account (Technical Account)

	Particulars	Schedule	Current Year (Rs.'000)	Previous Year (Rs.'000).
	Premiums earned – net			
	(a) Premium	1		
	(b) Reinsurance ceded			
	(c) Reinsurance accepted-			
	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)			
	<b>TOTAL (A)</b>			
	Commission	2		
	Operating Expenses related to Insurance Business	3		
	Provision for doubtful debts			
	Bad debts written off			



## Advanced Accounting

Provision for Tax			
Provisions (other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Others (to be specified)			
<b>TOTAL (B)</b>			
Benefits Paid (Net)	<b>4</b>		
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			
<b>TOTAL (C)</b>			
<b>SURPLUS/ (DEFICIT) (D) =(A)-(B)-(C)</b>			
<b>APPROPRIATIONS</b>			
Transfer to Shareholders' Account			
Transfer to Other Reserves (to be specified)			
Balance being Funds for Future Appropriations			
<b>TOTAL (D)</b>			

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)].



**Financial Statements of Insurance Companies**

*See Notes appended at the end of Form A-PL*

**FORM A-PL**

<b>Name of the Insurer:</b>
<b>Registration No. and Date of Registration with the IRDA</b>

**PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31<sup>ST</sup> MARCH, 20\_\_.**

**Shareholders' Account (Non-technical Account)**

	Particulars	Schedule	Current Year	Previous Year
			<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
	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)			
	<b>TOTAL (A)</b>			
	Expense other than those directly related to the insurance business			
	Bad debts written off			
	Provisions (Other than taxation)			



## Advanced Accounting

(a) For diminution in the value of investments (Net)			
(b) Provision for doubtful debts			
(c) Others (to be specified)			
<b>TOTAL (B)</b>			
Profit/ (Loss) before tax			
Provision for Taxation			
Profit / (Loss) after tax			
<b>APPROPRIATIONS</b>			
(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.*



## Financial Statements of Insurance Companies

- (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 31<sup>ST</sup> MARCH, 20\_\_\_\_.

	Schedule	Current Year	Previous Year
		(Rs. '000).	(Rs. '000).
<b>SOURCES OF FUNDS</b>			
<i>SHAREHOLDERS' FUNDS:</i>			
SHARE CAPITAL	5		
RESERVES AND SURPLUS	6		
CREDIT/[DEBIT] FAIR VALUE CHANGE ACCOUNT			
<b>Sub-Total</b>			
BORROWINGS	7		
<i>POLICYHOLDERS' FUNDS:</i>			
CREDIT/[DEBIT] FAIR VALUE CHANGE ACCOUNT			
POLICY LIABILITIES			
INSURANCE RESERVES			
PROVISION FOR LINKED LIABILITIES			
<b>Sub-Total</b>			
FUNDS FOR FUTURE APPROPRIATIONS			



## Advanced Accounting

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		
<b>Sub-Total (A)</b>			
CURRENT LIABILITIES	13		
PROVISIONS	14		
<b>Sub-Total (B)</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)			
<b>TOTAL</b>			



## Financial Statements of Insurance Companies

### CONTINGENT LIABILITIES

	Particulars	Current Year	Previous Year
		<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
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)		
	<b>TOTAL</b>		

### SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

#### SCHEDULE - 1

#### PREMIUM

	Particulars	Current Year	Previous Year
		<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
1	First year premiums		
2	Renewal Premiums		
3	Single Premiums		
	<b>TOTAL PREMIUM</b>		





**SCHEDULE- 2**

**COMMISSION EXPENSES**

Particulars	Current Year	Previous Year
	<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
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
		<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
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		



## Financial Statements of Insurance Companies

	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		
	<b>TOTAL</b>		

*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		



## Advanced Accounting

3. Amount accepted in reinsurance:		
(a) Claims by Death,		
(b) Claims by Maturity,		
(c) Annuities/Pension payment,		
(d) Other benefits, specify		
<b>TOTAL</b>		

*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 (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		
4.	Called-up Capital		
	Equity Shares of Rs. ....each		
	<i>Less</i> : Calls unpaid		
	<i>Add</i> : Shares forfeited (Amount originally paid up)		
	<i>Less</i> : Par value of Equity Shares bought back		



## Financial Statements of Insurance Companies

	Less : Preliminary Expenses Expenses including commission or brokerage on Underwriting or subscription of shares		
	<b>TOTAL</b>		

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 <ul style="list-style-type: none"><li>• Indian</li><li>• Foreign</li></ul>				
Others				
<b>TOTAL</b>				

### SCHEDULE – 6

#### RESERVES AND SURPLUS

	Particulars	Current Year	Previous Year
		(Rs. '000)	(Rs. '000)
1.	Capital Reserve		
2.	Capital Redemption Reserve		



## Advanced Accounting

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		
	<b>TOTAL</b>		

*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)		
	<b>TOTAL</b>		

*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*



**Financial Statements of Insurance Companies**

**SCHEDULE- 8**

**INVESTMENTS-SHAREHOLDERS**

	Particulars	Current Year	Previous Year
		<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
	<b>LONG TERM INVESTMENTS</b>		
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		
	<b>SHORT TERM INVESTMENTS</b>		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(aa) Equity		
	(bb) Preference		



## Advanced Accounting

	(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		
	<b>TOTAL</b>		

*Note: See Notes appended at the end of Schedule- 8B*

### SCHEDULE- 8A

#### INVESTMENTS-POLICYHOLDERS

	Particulars	Current Year	Previous Year
		<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
	<b>LONG TERM INVESTMENTS</b>		
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		



**Financial Statements of Insurance Companies**

4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	<b>SHORT TERM INVESTMENTS</b>		
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		
	<b>TOTAL</b>		

*Note: See Notes appended at the end of Schedule- 8B*

**SCHEDULE- 8B**

**ASSETS HELD TO COVER LINKED LIABILITIES**

	Particulars	Current Year	Previous Year
		<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
	<b>LONG TERM INVESTMENTS</b>		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares		





## Advanced Accounting

	(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		
	<b>SHORT TERM INVESTMENTS</b>		
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		
	<b>TOTAL</b>		

*Notes (applicable to Schedules 8 and 8A & 8B):*

*(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.*



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## Financial Statements of Insurance Companies

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- (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		
	<i>Secured</i>		
	(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)		
	<i>Unsecured</i>		
	<b>TOTAL</b>		
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)		
	<b>TOTAL</b>		
3.	PERFORMANCE-WISE CLASSIFICATION		
	(a) Loans classified as standard		
	(aa) In India		
	(bb) Outside India		



**Financial Statements of Insurance Companies**

	(b) Non-standard loans less provisions		
	(aa) In India		
	(bb) Outside India		
	<b>TOTAL</b>		
4.	<b>MATURITY-WISE CLASSIFICATION</b>		
	(a) Short Term		
	(b) Long Term		
	<b>TOTAL</b>		

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/ Adjustments	To Date	As at year end	Previous Year
Goodwill										
Intangibles (specify)										



**Advanced Accounting**

Land- Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
<b>TOTAL</b>										
Work in progress										
<b>Grand Total</b>										
<b>PREVIOUS YEAR</b>										

*Note:*

*Assets included in land, property and building above exclude Investment Properties as defined in note (e) to Schedule 8.*



## Financial Statements of Insurance Companies

### 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)		
	<b>TOTAL</b>		
	Balances with non-scheduled banks included in 2 and 3 above		
	<b>CASH &amp; BANK BALANCES</b>		
1	In India		
2	Outside India		
	<b>TOTAL</b>		

*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
		<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
	<b>ADVANCES</b>		
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)		
	<b>TOTAL (A)</b>		
	<b>OTHER ASSETS</b>		
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)		
	<b>TOTAL (B)</b>		
	<b>TOTAL (A+B)</b>		



## Financial Statements of Insurance Companies

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 (Rs. '000).	Previous Year (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)		
	<b>TOTAL</b>		





**SCHEDULE - 14**

**PROVISIONS**

	Particulars	Current Year	Previous Year
		<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
1.	For taxation (less payments and taxes deducted at source)		
2.	For proposed dividends		
3.	For dividend distribution tax		
4.	Others (to be specified)		
	<b>TOTAL</b>		

**SCHEDULE - 15**

**MISCELLANEOUS EXPENDITURE**

**(To the extent not written off or adjusted)**

	Particulars	Current Year	Previous Year
		<i>(Rs. '000).</i>	<i>(Rs. '000).</i>
1.	Discount Allowed in issue of shares/ debentures		
2.	Others (to be specified)		
	<b>TOTAL</b>		

*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



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## Financial Statements of Insurance Companies

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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.



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## Financial Statements of Insurance Companies

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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



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## Financial Statements of Insurance Companies

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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;





## **Advanced Accounting**

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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



## Financial Statements of Insurance Companies

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 31<sup>ST</sup> MARCH, 20\_\_.

	Particulars	Schedule	Current Year (Rs.'000)	Previous Year (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			
	<b>TOTAL (A)</b>			
1.	Claims Incurred (Net)	2		
2.	Commission	3		



## Advanced Accounting

3.	Operating Expenses related to Insurance Business	4		
	<b>TOTAL (B)</b>			
	<b>Operating Profit/(Loss) from Fire/Marine/Miscellaneous Business C= (A - B)</b>			
	<b>APPROPRIATIONS</b>			
	Transfer to Shareholders' Account			
	Transfer to Catastrophe Reserve			
	Transfer to Other Reserves (to be specified)			
	<b>TOTAL (C)</b>			

### FORM B-PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

### PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31<sup>ST</sup> 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)			
	<b>TOTAL (A)</b>			



**Financial Statements of Insurance Companies**

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)			
	<b>TOTAL (B)</b>			
	Profit Before Tax			
	Provision for Taxation			
	<b>APPROPRIATIONS</b>			
	(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.*



## Advanced Accounting

- (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 31<sup>ST</sup> MARCH, 20\_\_.

	Schedule	Current Year	Previous Year
		(Rs.'000)	(Rs.'000)
<b>SOURCES OF FUNDS</b>			
SHARE CAPITAL	5		
RESERVES AND SURPLUS	6		
FAIR VALUE CHANGE ACCOUNT			
BORROWINGS	7		
<b>TOTAL</b>			
<b>APPLICATION OF FUNDS</b>			
INVESTMENTS	8		
LOANS	9		
FIXED ASSETS	10		
CURRENT ASSETS			



### Financial Statements of Insurance Companies

Cash and Bank Balances	11		
Advances and Other Assets	12		
<b>Sub-Total (A)</b>			
CURRENT LIABILITIES	13		
PROVISIONS	14		
<b>Sub-Total (B)</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			
<b>TOTAL</b>			

### 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)		
	<b>TOTAL</b>		



**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		
	<b>Total Premium Earned (Net)</b>		

*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		
	<b>Total Claims Incurred</b>		



## Financial Statements of Insurance Companies

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		





## Advanced Accounting

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		
	<b>TOTAL</b>		

*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		



## Financial Statements of Insurance Companies

	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		
	<b>TOTAL</b>		

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				
<ul style="list-style-type: none"> <li>• Indian</li> <li>• Foreign</li> </ul>				
Others				
<b>TOTAL</b>				



**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		
	<b>TOTAL</b>		

*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)		
	<b>TOTAL</b>		

*Notes:*

*(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.*



**Financial Statements of Insurance Companies**

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately

**SCHEDULE -8**

**INVESTMENTS**

	Particulars	Current Year	Previous Year
		<i>(Rs. '000)</i>	<i>(Rs. '000)</i>
	<b>LONG TERM INVESTMENTS</b>		
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		
	<b>SHORT TERM INVESTMENTS</b>		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		



## Advanced Accounting

	(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		
	<b>TOTAL</b>		

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*



## Financial Statements of Insurance Companies

*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		
	<b>TOTAL</b>		



## Advanced Accounting

2.	BORROWER-WISE CLASSIFICATION		
	(a) Central and State Governments		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Industrial Undertakings		
	(e) Others (to be specified)		
	<b>TOTAL</b>		
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		
	<b>TOTAL</b>		
4.	MATURITY-WISE CLASSIFICATION		
	(a) Short Term		
	(b) Long Term		
	<b>TOTAL</b>		

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.



**Financial Statements of Insurance Companies**

**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)										
<b>TOTAL</b>										
Work in progress										
<b>Grand Total</b>										
<b>PREVIOUS YEAR</b>										

*Note: Assets included in land, building and property above exclude Investment Properties as defined in note (e) to Schedule 8.*





## Advanced Accounting

### 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)		
	<b>TOTAL</b>		
	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)
	<b>ADVANCES</b>		
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		



### Financial Statements of Insurance Companies

5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	<b>TOTAL (A)</b>		
	<b>OTHER ASSETS</b>		
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)		
	<b>TOTAL (B)</b>		
	<b>TOTAL (A+B)</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)		
	<b>TOTAL</b>		

**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)		
	<b>TOTAL</b>		



## Financial Statements of Insurance Companies

### 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)		
	<b>TOTAL</b>		

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;



## Advanced Accounting

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- (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:-



## Financial Statements of Insurance Companies

- (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, 2006 in the books on the National Life Assurance Co. Ltd., prepare Profit and Loss Account and Balance Sheet.

	<i>'000 Rs.</i>		<i>'000 Rs.</i>
Life Assurance Fund on 1st April, 2005	34,00,000	Agents' Balances	18,000
Annuities paid (in India 72,500)	81,750	Advances to ceding companies	47,000
		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



## Advanced Accounting

		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 guaranteed by the Government	4,50,000	Bank Loan	21,750
Stocks of Shares of companies incorporated in India	14,50,000	Salaries	30,400
Share Capital (20,000 shares @ Rs. 100 each)	20,00,000	Auditors' Fees	5,000
Mortgages in India	14,32,500	Law Charges	3,400
Cash with Bankers on Current Account	40,500	Rent paid	3,600
Cash with Bankers on Deposit (short-term) Account	20,000	Other Expenses of Management	750
Cash in hand	7,000	Travelling Expenses	1,950
State Government Securities	7,25,000	Interest and Rents Received (Gross)	1,95,000
Furniture and Fixtures	39,000	Proposed dividend @ 10%	
Outstanding Premiums	66,000		

Transfer the surplus amount if any to Life Fund for the year ended 31st March, 2006 5% Dividend is also proposed.

**Solution :**

IN THE BOOKS OF NATIONAL ASSURANCE CO. LTD.

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 2006

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)	



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**Financial Statements of Insurance Companies**

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(c) Reinsurance accepted		<u>50,000</u>
		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)		_____
<b>Total (A)</b>		<u>9,06,000</u>
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)		_____
<b>Total (B)</b>		<u>96,000</u>
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		_____
<b>Total (C)</b>		<u>5,24,250</u>
<b>Surplus [(A) – (B) – (D)]</b>		<u>2,85,750</u>
<b>APPROPRIATIONS</b>		
Transfer to Shareholders' Account		
Transfer to Other Reserves (to be specified)		
Transfer to Funds for Future Appropriations		<u>1,85,750</u>
<b>Total (D)</b>		<u>1,85,750</u>





Form A-PL

PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31<sup>ST</sup> 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)			
<b>Total (A)</b>			
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)			
<b>Total (B)</b>			
Profit/(Loss) before tax			
Provision for Taxation			
Profit/(Loss) after tax			
<b>APPROPRIATIONS</b>			
(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)		<u>85,750</u>	
Profit carried forward to the Balance Sheet		<u>1,85,750</u>	

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.



## Financial Statements of Insurance Companies

- (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 31<sup>ST</sup> MARCH, 2006

#### Shareholders' Account (Non-technical Account)

	Schedule	Current Year (Rs. '000)	Previous Year (Rs. '000)
<b>SOURCES OF FUNDS</b>			
Shareholders' Funds			
Share Capital	5	20,00,000	
Reserves and Surplus	6	38,10,750	
Credit/[Debit] Fair value change account			
<b>Sub-Total</b>			
Borrowings	7	69,250	
Policyholders' Funds			
Credit/[Debit] Fair value change account			



## Advanced Accounting

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Policy Liabilities		
Insurance reserves		
Provision for linked liabilities		
<b>Sub-Total</b>		
Funds for future appropriations		
<b>Total</b>		<u>58,80,000</u>
<b>APPLICATION OF FUNDS</b>		
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	<u>1,69,500</u>
<b>Sub-Total (A)</b>		<u>2,37,000</u>
Current Liabilities	13	1,800
Provisions	14	<u>1,00,000</u>
<b>Sub-Total (B)</b>		<u>1,01,800</u>
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)		
<b>Total</b> [Sch.8,9,10 & (C)]		<u>58,80,000</u>



## Financial Statements of Insurance Companies

### 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		
<b>Total premiums</b>	<u>7,10,000</u>	
Particulars	Current Year (Rs. '000)	Previous Year (Rs. '000)
<b>Premiums Income from business written :</b>		
1. In India		
2. Outside India		
<b>Total premiums (Net)</b>		

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		
<i>Add : Commission on Re-insurance Accepted</i>	12,000	
<i>Less : Commission on Re-insurance Ceded</i>	<u>(4,000)</u>	
Net Commission	<u>50,500</u>	



## Advanced Accounting

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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	—	
<b>Total</b>	<b><u>45,500</u></b>	

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.



## Financial Statements of Insurance Companies

(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		
<b>Total</b>	<u>5,01,750</u>	
<b>Benefits paid to claimants :</b>		
1. In India	3,42,500	
2. Outside India	<u>1,59,250</u>	
Total Benefits paid (Net)	<u>5,01,750</u>	

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



## Advanced Accounting

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### 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. <i>Less</i> : Calls unpaid		
<i>Add</i> : Share forfeited (Amount Originally paid up)		
<i>Less</i> : Par value of Equity Shares bought back		
<i>Less</i> : Preliminary Expenses Expenses including commission or brokerage on Underwriting or subscription of shares		
<b>Total</b>	<u>20,00,000</u>	

*Notes :*

- Particulars of the different classes of capital should be separated stated.*
- The amount capitalised on account of issue of bonus shares should be disclosed.*
- In case any part of the capital is held by a holding company, the same should be separately disclosed.*



## Financial Statements of Insurance Companies

### 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				
I Indian				
I Foreign				
Others				
<b>Total</b>				

### SCHEDULE-6 RESERVES AND SURPLUS

Particulars	Current	Previous
	Year (Rs. '000)	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		
<b>Total</b>	<b><u>38,10,750</u></b>	<b><u>36,25,000</u></b>

Notes :

*Additions to and deductions from the reserves should be disclosed under each of the specified heads.*





## Advanced Accounting

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### 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)		
<b>Total</b>	<u>71,050</u>	

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	



## Financial Statements of Insurance Companies

Securities guaranteed by the Government	4,50,000
Stock and shares of companies incorporated in India	<u>14,50,000</u>
	<u>40,00,000</u>

### 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)		
<b>Total</b>	<u>16,42,500</u>	
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)		
<b>Total</b>		
3. Performance-wise classification		
(a) Loans classified as standard		
(aa) In India		



## Advanced Accounting

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- (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

Particulars	Cost/Gross Block	Depreciation	(Rs. '000) Net Block
Goodwill			
Intangibles (specify)			
Land-Freehold			
Leasehold Property			63,300
Buildings			
Furniture & Fittings			39,000



## Financial Statements of Insurance Companies

Information Technology	
Equipment	
Vehicles	
Office Equipment	
Others (Specify nature)	
Total	<u>1,02,300</u>

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)		
<b>Total</b>	<u>67,500</u>	

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, 2006 :

	(Rs. in '000)
Capital	320,00
Balances of Funds as on 1.4.05	
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	<u>30,00</u>
	510,00
Foreign Taxes—Marine	8,00
Outstanding premium	82,00



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**Financial Statements of Insurance Companies**

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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	<u>68,00</u>	876,90
Premium Less Re-insurance		
Fire	1762,50	
Marine	1022,50	
Miscellaneous	<u>262,25</u>	3047,25
Interest and Dividends Received on Investments		58,50
Tax Deducted at Source		11,70
Commission		
Fire	500,00	
Marine	350,00	
Miscellaneous	<u>80,00</u>	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



## Advanced Accounting

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Outstanding claims as on 31.3.06

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 31<sup>st</sup> March, 2006**

**Fire and Marine and Misc Insurance Businesses**

	<i>Schedule</i>	<i>Fire</i>	<i>Marine</i>	<i>Misc.</i>
	<i>e</i>	<i>Current</i>	<i>Current</i>	<i>Current</i>
		<i>Year</i>	<i>Year</i>	<i>Year</i>
		<i>Rs. '000</i>	<i>Rs. '000</i>	<i>Rs. '000</i>
Premiums earned (net)	1	1762,50	1022,50	262,25
Change in provision for unexpired risk		(-)81,25	(-) 72,50	87,52
Interest, Dividends and Rent – Gross		—	—	—
Double Income Tax refund		—	—	—
Profit on sale of motor car		—	—	—
Total (A)		<u>1681,25</u>	<u>950,00</u>	<u>349,77</u>
Claims incurred (net)	2	650,00	408,90	100,50
Commission	3	500,00	350,00	80,00
Operating expenses related to	4			



**Financial Statements of Insurance Companies**

Insurance business	280,00	160,00	40,00
Bad debts	—	—	—
Indian and Foreign taxes	<u>—</u>	<u>8,00</u>	<u>—</u>
Total (B)	<u>1430,00</u>	<u>926,90</u>	<u>220,50</u>
Profit from Marine Insurance business (A–B)	251,25	23,10	129,27

**Schedules forming part of Revenue Account**

Schedule –1

<i>Premiums earned (net)</i>	<i>Fire Current Year Rs. '000</i>	<i>Marine Current Year Rs'000.</i>	<i>Misc. Current Year Rs. '000</i>
Premiums <i>Less</i> reinsurance (net)	1762,50	1022,50	262,25

Schedule – 2

Claims incurred (net)	650,00	408,90	100,50
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Schedule – 3

Commission paid	500,00	350,00	80,00
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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, 2006**

<i>Particulars</i>	<i>Sche dule</i>	<i>Current Year Rs. ' (000)</i>	<i>Previous Year Rs. ' (000)</i>
<b>Operating Profit/(Loss)</b>			
(a) Fire Insurance		251,25	





## Advanced Accounting

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(b) Marine Insurance	23,10
(c) Miscellaneous	129,27
<b>Income From Investments</b>	
(a) Interest, Dividend & Rent–Gross	58,50
<b>Other Income</b>	
Transfer Fees	<u>1,00</u>
Total (A)	<u>463,12</u>
<b>Provisions (Other than taxation)</b>	
Depreciation of Furniture	10,00
Depreciation of Investments	10,00
<b>Other Expenses –</b>	
Expenses of Management	30,00
Donation	<u>10,00</u>
Total (B)	<u>60,00</u>
Profit Before Tax	403,12
Provision for Taxation	<u>206,56</u>
Profit After Tax	196,56
<b>Profit</b>	
(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 :

- Reserve for unexpired risk 50% of net premium for fire and miscellaneous and 100% of net premium for marine.
- Provision for Taxation Rs.  
Net Profit before tax 403,12



## Financial Statements of Insurance Companies

Add: Donation	10,00
Taxable Profit	<u>413,12</u>
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, 2006 :

	Direct Business	Re-Insurance
	Rs.	Rs.
Claim paid during the year	46,70,000	7,00,000
Claim Payable— 1st April, 2005	7,63,000	87,000
31st March, 2006	8,12,000	53,000
Claims received	–	2,30,000
Claims Receivable— 1st April, 2005	–	65,000
31st March, 2006	–	1,13,000
Expenses of Management (includes Rs. 35,000 Surveyor's fee and Rs. 45,000 Legal expenses for settlement of claims)	2,30,000	–

### 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	
	<u>59,72</u>	
Less : Outstanding claims at the beginning of the year	7,85	51,87



## Advanced Accounting

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### Working Notes :

	<i>Rs. '000</i>	<i>Rs. '000</i>
1. Claims paid during the year		
Direct business	46,70	
Reinsurance	<u>7,00</u>	53,70
<i>Add</i> : Surveyor's fee	35	
Legal expenses	<u>45</u>	<u>80</u>
		54,50
<i>Less</i> : Claims received from re-insurers		<u>2,30</u>
		<u>52,20</u>
2. Claims outstanding on 31st March, 2006		
Direct business	8,12	
Reinsurance	<u>53</u>	8,65
<i>Less</i> : Claims receivable from re-insurers		<u>1,13</u>
		<u>7,52</u>
3. Claims outstanding on 1st April, 2005		
Direct business	763	
Reinsurance	<u>87</u>	8,50
<i>Less</i> : Claims receivable from re-insurers		<u>65</u>
		<u>7,85</u>

### Illustration 4

From the following balances extracted from the books of Perfect General Insurance Company Limited as on 31.3.2006 you are required to prepare Revenue Accounts in respect of Fire and marine Insurance business for the year ended 31.3.2006 to and a Profit and Loss Account for the same period :

Directors' Fees	Rs. 80,000	Interest received	Rs. 19,000
Dividend received	1,00,000	Fixed Assets (1.4.1999)	90,000
Provision for Taxation (as on 1.4. 2005)	85,000	Income-tax paid during the year	60,000



## Financial Statements of Insurance Companies

	Fire	Marine
Outstanding Claims on 1.4.2005	28,000	7,000
Claims paid	1,00,000	80,000
Reserve for Unexpired Risk on 1.4.2005	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 :

- Depreciation on Fixed Assets to be provided at 10% p.a.
- Interest accrued on investments Rs. 10,000.
- Closing provision for taxation on 31.3.2006 be maintained at Rs. 1,24,138
- Claims outstanding on 31.3.2006 were Fire Insurance Rs. 10,000; Marine Insurance Rs. 15,000.
- Premium outstanding on 31.3.2006 were Fire Insurance Rs. 30,000; Marine Insurance Rs. 20,000.
- Reserve for unexpired risk to be maintained at 50% and 100% of net premiums in respect of Fire and Marine Insurance respectively.
- Expenses of management due on 31.3.2006 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 31<sup>st</sup> March, 2006**

**Fire and Marine Insurance Businesses**

	<i>Schedule</i>	<i>Fire Current Year Rs.</i>	<i>Marine Current Year Rs.</i>
Premiums earned (net)	1	4,55,000	3,35,000
Change in provision for unexpired risk		(-)27,500	(-) 1,95,000



## Advanced Accounting

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Interest, Dividends and Rent – Gross		—	—
Double Income Tax refund		—	—
Profit on sale of motor car		<u>—</u>	<u>—</u>
Total (A)		<u>4,27,500</u>	<u>1,40,000</u>
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		<u>—</u>	<u>—</u>
Total (B)		<u>1,92,000</u>	<u>1,58,000</u>
Profit from Marine Insurance business ( A-B)		2,35,500	(18000)

### Schedules forming part of Revenue Account

#### Schedule –1

<i>Premiums earned (net)</i>	<i>Fire Current Year Rs.</i>	<i>Marine Current Year Rs.</i>
Premiums from direct business written	4,80,000	3,50,000
<i>Less: Premium on reinsurance ceded</i>	<u>25,000</u>	<u>15,000</u>
Total Premium earned (net)	<u>4,55,000</u>	<u>3,35,000</u>

#### Schedule – 2

Claims incurred (net)	<u>82,000</u>	<u>88,000</u>
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#### Schedule – 4

Operating expenses related to insurance business		
Expenses of Management	70,000	50,000



**Financial Statements of Insurance Companies**

Form B-PL  
Perfect General Insurance Co. Ltd.  
Profit and Loss Account for the year 31st March, 2006

<i>Particulars</i>	<i>Schedule</i>	<i>Current Year</i>	<i>Previous Year</i>
		<i>Rs.</i>	<i>Rs.</i>
<b>Operating Profit/(Loss)</b>			
(a) Fire Insurance		2,35,500	
(b) Marine Insurance		(18,000)	
(c) Miscellaneous Insurance		—	
<b>Income From Investments</b>			
(b) Interest, Dividend & Rent–Gross		1,29,000	
(c) Profit on sale of investments			
Less : Loss on sale of investments			
<b>Other Income (To be specified)</b>			
Total (A)		<u>3,46,500</u>	
<b>Provisions (Other than taxation)</b>			
Depreciation		9,000	
<b>Other Expenses –Director’s Fee</b>		<del>80,000</del>	
Total (B)		<u>89,000</u>	
Profit Before Tax		2,57,500	



## Advanced Accounting

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Provision for Taxation	—99,138
Profit After Tax	<u>1,58,362</u>

### Working Notes :

	<i>Fire</i> <i>Rs.</i>	<i>Marine</i> <i>Rs.</i>
1. Claims under policies less reinsurance		
Claims paid during the year	1,00,000	80,000
Add: Outstanding on 31st March, 2006	<u>10,000</u>	<u>15,000</u>
	1,10,000	95,000
Less : Outstanding on 1st April, 2005	<u>28,000</u>	<u>7,000</u>
	<u>82,000</u>	<u>88,000</u>
2. Expenses of management		
Expenses paid during the year	60,000	45,000
Add: Outstanding on 31st March, 2006	<u>10,000</u>	<u>5,000</u>
	<u>70,000</u>	<u>50,000</u>
3. Premiums less reinsurance		
Premiums received during the year	4,50,000	3,30,000
Add: Outstanding on 31st March, 2005	<u>30,000</u>	<u>20,000</u>
	4,80,000	3,50,000
Less : Reinsurance premiums	<u>25,000</u>	<u>15,000</u>
	<u>4,55,000</u>	<u>3,35,000</u>
4. Reserve for unexpired risks is 50% of net premium for fire insurance and 100% of net premium for marine insurance.		
5. <b>Provision for taxation account</b>		
	<i>Rs.</i>	<i>Rs.</i>
31.3.2006 To Bank A/c	1.4.2005	By Balance b/d
(taxes paid)	60,000	85,000
	31.3.2006	By P & L A/c
		99,138



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### Financial Statements of Insurance Companies

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31.3.2006 To Balance c/d	<u>1,24,138</u>	<u>          </u>
	<u>1,84,138</u>	<u>1,84,138</u>

#### Self Examination Questions

##### I. Objective Type Questions

Choose the most appropriate answer from the given options:

- As per IRDA Regulations, 2002, Sun Light Insurance Company carrying business of more than one type of insurance business is required to prepare
  - A separate revenue account for each type of business.
  - A separate profit and loss account for each type of business.
  - A separate balance sheet for each type of business.
  - A separate revenue and profit and loss account for each type of business but a combined balance sheet.
- In case of fire insurance, the provision required to make against unexpired risks is
  - 40%.
  - 50%.
  - 100%.
  - 30%
- As per IRDA Regulations, an insurance company is required to prepare
  - Revenue account.
  - Profit and loss account.
  - Balance sheet.
  - All of the above.

[Answer 1 (a); 2 (b); 3(d)]

##### II. Short Answer Type Questions

- Write a note on computation of 'premium income' and 'commission expense' in the case of an insurance company.
- Explain the presentation in the financial statements of the following items:
  - Claims paid on re-insurance business.
  - 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, 2006, prepare the Revenue Accounts of Sagar Bhima Co. Ltd. engaged in Marine Insurance Business:

<i>Particulars</i>	<i>Direct Business</i>	<i>Re-insurance</i>
	<i>(Rs.)</i>	<i>(Rs.)</i>
I. Premium :		
Received	24,00,000	3,60,000
Receivable – 1st April, 2005	1,20,000	21,000
– 31st March, 2006	1,80,000	28,000
Premium paid	2,40,000	–
Payable – 1st April, 2001	–	20,000
– 31st March, 2002	–	42,000
II. Claims :		
Paid	16,50,000	1,25,000
Payable – 1st April, 2005	95,000	13,000
– 31st March, 2006	1,75,000	22,000
Received	–	1,00,000
Receivable – 1st April, 2005	–	9,000
– 31st March, 2006	–	12,000
III. Commission :		
On Insurance accepted	1,50,000	11,000
On Insurance ceded	–	14,000



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## Financial Statements of Insurance Companies

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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, 2005 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 2006, 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 undermentioned figures amongst others appeared in the books of Y General Insurance Co. Ltd., as on 31st March, 2006.

	<i>Rs.</i>
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, 2006 totalling Rs. 38,000. Which is the amount that will be debited to the Revenue Account in respect of claims?



## Advanced Accounting

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10. X Fire Insurance Co. Ltd. commenced in 2006 for which year its books showed the following :

	<i>Rs.</i>
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 ELECTRICITY COMPANIES

### UNIT-1: DOUBLE ACCOUNTS SYSTEM

#### Learning Objectives

After studying this unit, you will be able to:

- ◆ Learn the techniques of preparing a Revenue Account and Net Revenue Account under Double Accounts System.
- ◆ Learn how to present receipts and payments of capital account and how to prepare general balance sheet. Try to understand how to carry forward such balances from receipts and expenditure on capital accounts.
- ◆ 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.

#### 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.

The final accounts, prepared under the 'Double Accounts System' normally consist of :

- (a) Revenue Account,
- (b) Net Revenue Account,
- (c) Capital Account (Receipts & Expenditure on Capital Account), and
- (d) General Balance Sheet.

(a) *Revenue Account* : This account is analogous to the Profit and Loss Account of a trading concern showing on the debit side various items of expenditure and, on the credit side, various items of income. It should be noted that depreciation is debited to the Revenue Account but credited to Depreciation Reserve and not to the asset concerned.

(b) *Net Revenue Account* : This account is analogous to the Profit and Loss Appropriation Account of a trading concern but differs from it in one important respect. This is that interest items, such as on loans and debentures, are treated as an appropriation out of profit and are shown in the Net Revenue Account. Such a treatment is required as debentures and loan are considered as a part of the capital of the concern. This is in sharp contrast with the practice



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## Financial Statements of Electricity Companies

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followed for preparing accounts of an ordinary concern in which case the loan and debenture interest is treated as a charge against profit and shown in the Profit and Loss Account.

(c) *Receipts and Payments on Capital Account and General Balance Sheet* : Under the Double Accounts System the balance sheet is split into two parts: Receipts and Expenditure on Capital Account and General Balance Sheet.

The main purpose of the former is to show :

- (i) the total amount of capital raised and its sources; and
- (ii) the manner and extent to which this capital has been applied in the acquisition of fixed assets for the purpose of carrying on the business of the undertaking.

It thus discloses the receipts and expenditure on capital account, that is, the receipts from issue of shares, debentures and loans and the expenditure, out of such receipts, on acquisition of and addition to fixed assets. The Receipts and Expenditure on Capital Account is shown in a columnar form. There are three money columns: (i) one showing the amount at the commencement of the period; (ii) another disclosing the amount received or spent during the period; and (iii) the third showing the balance left at the end of the period.

Preliminary expenses on formation are treated as capital expenditure and shown on the "Expenditure" side and premium received on issue of shares or debentures is deducted from the proceeds of the issue and the proceeds are shown net.

In the case of electricity supply companies, the capital receipts and total capital expenditure, include all other assets and liabilities. It is drawn up in the usual way, showing on the left hand side, reserves, depreciation fund, current liabilities and other credit balances and, on the right hand side, the floating assets and other debit balances.

### 1.1 CHARACTERISTIC FEATURES OF THE SYSTEM

- (a) The Balance Sheet is presented in two parts, viz. Capital Account and General Balance Sheet.
- (b) The Capital Account shows the total expenditure to date on assets which may or may not be in existence at the date of the account.
- (c) Loan and debenture interest is shown in the Net Revenue Account as an appropriation of profits.
- (d) Depreciation is not shown as deduction from the cost of assets but as an accumulated fund in the General Balance Sheet.
- (e) Renewals are provided for out of current revenue.
- (f) Discount and premium on issue of shares and debentures are permanently retained as



capital items.

- (g) The published accounts are usually accompanied by voluminous statements.

### **1.2 ADVANTAGES OF THE SYSTEM**

- (a) A public utility concern frequently enjoys monopoly rights granted by the State. A prescribed form in which accounts must be presented is one of the controls exercised by the State to ensure that the concern earns consistent and reasonable return on the capital employed and also it renders the cheapest and the most efficient service to the public.
- (b) The Capital Account readily discloses the sources of capital, the manner in which it is utilised and the under or over-capitalisation, if any.
- (c) The Net Revenue Account segregates from the Revenue Account all items which are extraneous to the actual working of the concern. Therefore, the Revenue Account discloses the periodical results of the “pure” operating activities of the concern.
- (d) The standardisation of the form in which the accounts are presented by concerns rendering similar services, e.g., electricity companies, provides a ready basis for the preparation of statistical statements.

### **1.3 DISADVANTAGES OF THE SYSTEM**

- (a) All assets remain at cost, and unless a Depreciation Fund is built up, the true position is not shown.
- (b) Where an item, having a short life is included in Capital Account, the asset continues to appear in the account long after it has been used up.
- (c) Unless Replacement Fund is formed, the varying charge for replacement distorts the various years’ results.
- (d) It is not always possible to arrive at the exact amount to be charged to revenue on replacement of an asset by the construction of new and improved asset.
- (e) The accounts are not easily understood by the general public.

#### **Illustration 1**

The following balances are extracted from the Books of Flash Light Electric Co. Ltd.

- (i) Fixed Assets : Expenditure upto 1-1-2005 :
- (a) Land and Building Rs. 10,00,000.
- (b) Machinery Rs. 15,00,000.



## Financial Statements of Electricity Companies

- (ii) Additions during the years: Machinery Rs. 3,50,000.
- (iii) Depreciation Fund :
  - (a) Machinery Rs. 3,00,000.
  - (b) Building Rs. 1,00,000.
- (iv) Authorised Capital Rs. 50,00,000 divided into equity shares of Rs. 100 each.
- (v) Issued and fully paid up 20,000 equity shares of Rs. 100 each (including 2,500 equity shares issued during the year).
- (vi) 7½% Debentures Rs. 10,00,000 secured by a charge on Fixed Assets.
- (vii) Sundry Creditors Rs. 2,50,000; Reserve Fund Rs. 5,00,000. Reserve Fund Investments at cost Rs. 5,00,000 ; Market Value Rs. 5,25,000.
- (viii) Stock Rs. 3,02,500; Sundry Debtors Rs. 4,50,000; Cash at Bank Rs. 2,00,000; Cash in hand Rs. 50,000.
- (ix) Profit & Loss Account. (Cr.) Rs. 2,02,500.

You are instructed to prepare :

- (i) Balance Sheet as at 31st December, 2005, according to Schedule VI to the Companies Act, 1956 (Previous year's figures not required).
- (ii) (a) Capital Account, and  
(b) General Balance Sheet as at the same date under the Double Accounts System

### Solution

(I)

#### Flashlight Electric Co. Ltd.

#### Balance Sheet as at 31st Dec., 2005

(As per Schedule VI to the Companies Act)

<i>Liabilities</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Assets</i>	<i>Rs.</i>	<i>Rs.</i>
			<i>Fixed Assets</i>		
Share Capital			Land & Buildings		
Authorised : 50,000 Equity			(at cost)	10,00,000	
shares of Rs. 100 each	<u>50,00,000</u>		Less : Depreciation	<u>1,00,000</u>	9,00,000
Issued, Subscribed &			Machinery : (at cost)	15,00,000	
Paid up :			Additions during the year	<u>3,50,000</u>	





## Advanced Accounting

20,000 Equity Shares of Rs. 100 each fully paid	20,00,000		18,50,000	
		Less : Depreciation	<u>3,00,000</u>	15,50,000
<i>Reserves &amp; Surplus</i>				
Reserve Fund	5,00,000			
Profit & Loss A/c	<u>2,02,500</u>	7,02,500		
<i>Secured Loans :</i>		<i>Investments</i>		
7.5% Debentures (Secured by a charge on fixed assets)	10,00,000		Reserve Fund Investments at cost	5,00,000
			(Market value Rs. 5,25,000)	
<i>Unsecured Loans :</i>		<i>Current Assets and Loans and Advances</i>		
<i>Current Liabilities &amp; Provisions</i>		<i>Nil</i>	Stock	3,02,500
Sundry Creditors	2,50,000		Sundry Debtors	4,50,000
			Cash in hand	50,000
			Cash at Bank	<u>2,00,000</u>
			(assumed Scheduled)	10,02,500
		<u>39,52,500</u>		<u>39,52,500</u>

### FLASHLIGHT ELECTRIC CO. LTD.

#### Receipts & Expenditure on Capital Accounts for the year ended 31st December, 2005

	<i>Expenditure upto 31st Dec. 2004 Rs.</i>	<i>Expenditure during the year Rs.</i>	<i>Total Expenditure Rs.</i>		<i>Receipts upto 31st Dec. 2004 Rs.</i>	<i>Receipts during the year Rs.</i>	<i>Total Receipts Rs.</i>
Land and Buildings	10,00,000		10,00,000	Equity Share Capital	17,50,000	2,50,000	20,00,000
Machinery	<u>15,00,000</u>	<u>3,50,000</u>	<u>18,50,000</u>	7 ½ % Debentures	<u>10,00,000</u>	—	<u>10,00,000</u>
Total	25,00,000	3,50,000	28,50,000	Total	27,50,000	2,50,000	30,00,000
Balance of Capital Capital A/c	<u>2,50,000</u>	—	<u>1,50,000</u>	Balance of Capital A/c	—	<u>1,00,000</u>	—
	<u>27,50,000</u>	<u>3,50,000</u>	<u>30,00,000</u>		<u>27,50,000</u>	<u>3,50,000</u>	<u>30,00,000</u>



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## Financial Statements of Electricity Companies

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### General Balance Sheet as at December 31, 2005

	Rs.		Rs.
I. Total amount received as per Capital A/c	30,00,000	I. Total Capital Expenditure as per Capital Account	28,50,000
II. Sundry Creditors	2,50,000	II. Stores on hand	3,02,500
III. Net Revenue Account	2,02,500	III. Sundry Debtors	4,50,000
IV. Reserve Fund	5,00,000	IV. Securities (Investments) at cost (Market value Rs. 5,25,000)	5,00,000
V. Depreciation Fund	4,00,000	V. Cash and Bank	
		Balances	<u>2,50,000</u>
	<u>43,52,500</u>		<u>43,52,500</u>

*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



## Advanced Accounting

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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 2

The ABC Electricity Company decided to replace some parts of its plant by an improved plant. The plant to be replaced was built in 1985 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

	<i>Rs.</i>	<i>Rs.</i>
Estimated current cost of replacing old plant		40,00,000
<i>Less:</i> 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	<u>2,75,000</u>	<u>4,25,000</u>
Total		<u>35,75,000</u>
<i>Amount to be capitalised</i>		
Cost of building new plant (cash)	85,00,000	
<i>Add:</i> Value of materials belonging to the old plant in the construction of new plant	<u>2,75,000</u>	87,75,000
<i>Less:</i> Estimated current cost of replacing old plant		<u>40,00,000</u>
Total		<u>47,75,000</u>

The accounts will be as under :

<b>Plant Account</b>			
	<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	27,00,000	By Balance c/d	74,75,000



## Financial Statements of Electricity Companies

To Cost of Construction :			
Cash	45,00,000		
Cost of old materials used	<u>2,75,000</u>		
	<u>74,75,000</u>		<u>74,75,000</u>
To Balance b/d	74,75,000		

### Replacement Account

	<i>Rs.</i>		<i>Rs.</i>
To Bank-portion to be written off out of replacement cost	<u>40,00,000</u>	By Bank	1,50,000
	<u>40,00,000</u>	By Plant Account	2,75,000
		By Revenue Account	<u>35,75,000</u>
			<u>40,00,000</u>

### Illustration 3

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.

		<i>Rs.</i>	<i>Rs.</i>
Replacement Account	Dr.	13,80,000	
To Bank Account			13,80,000
<i>(Current cost of replacement of 3/4 Main charged to Replacement account)</i>			
New Main Account	Dr.	6,00,000	
To Bank Account			5,40,000
To Replacement Account			60,000
<i>(Cost incurred on laying auxiliary main including old material worth Rs. 60,000)</i>			
New Main Account	Dr.	4,20,000	
To Bank Account			3,80,000
To Replacement Account			40,000



## Advanced Accounting

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(Additional Cost of New Main capitalised  
including cost of old material used Rs. 40,000)

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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

	<i>Rs.</i>
Cost of 3/4 of old Main	12,00,000
<i>Add:</i> Increase in cost by 15%	<u>1,80,000</u>
	13,80,000
Cost of replacement	<u>18,00,000</u>
Additional cost of new Main (to be capitalised)	4,20,000
<i>Less:</i> Cost of old material	<u>40,000</u>
Additional cash cost of replacement	3,80,000

### Illustration 4

Bijlee Power Supply Co. Ltd., has built a power station and the connecting lines during the year 2002. The following further particulars are furnished to you :

- (i) In the year 2002, 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 2005 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 2005 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.



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## Financial Statements of Electricity Companies

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- (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 2002 and 2005. Working should form part of your answer.

### Solution

#### Bijlee Power Supply Co. Ltd.

#### Journal

		<i>Dr.</i>	<i>Cr.</i>
		<i>Rs.</i>	<i>Rs.</i>
(i)	2002 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 <u>Rs. 7,82,300 capitalised</u> )		
(ii)	2005 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 <u>Rs. 3,30,500 capitalised)*</u>		
	Bank A/c	Dr. 67,000	
	New Works A/c**	Dr. 75,000	
	To Replacement A/c		1,42,000

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\* 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.)



## Advanced Accounting

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(Cost of old material used in New Works Rs. 75,000 and  
balance sold for Rs. 67,000)

### Working Notes :

(1) Current Cost of Replacement :	<i>Rs.</i>
Cost in 2002	<u>47,58,000</u>
Cost of 20% of plant replaced	9,51,600
<i>Add:</i> Increase in cost 25%	<u>2,37,900</u>
Current cost of replacement	<u>11,89,500</u>

### Illustration 5

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

<i>Dr.</i>				<i>Cr.</i>
		<i>Rs.</i>		<i>Rs.</i>
To Balance b/d	24,00,000		By Balance c/d	49,20,000
To Bank A/c	22,80,000			
(Cost of new plant capitalised)				
To Replacement A/c	2,40,000			
(old parts)				
		<u>49,20,000</u>		<u>49,20,000</u>
To Balance b/d	49,20,000			



## Financial Statements of Electricity Companies

		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
		<u>37,20,000</u>		<u>37,20,000</u>

### 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%	<u>12,96,000</u>
			<u>29,76,000</u>
Overheads (1/4 of above or 1/5 of total)			7,44,000
Current replacement cost			<u>37,20,000</u>
Current replacement cost			37,20,000
Total cash cost			<u>60,00,000</u>
Amount capitalised, excluding old materials used			<u>22,80,000</u>

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.





## Advanced Accounting

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- (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. In Double Accounts System, the balance sheet is subdivided into
- (a) Profit and Loss Appropriation Account and General Balance Sheet.
  - (b) Revenue Account and Statement of Affairs
  - (c) Receipts and Expenditure on Capital Account and General Balance Sheet.
  - (d) Revenue Account And Profit And Loss Appropriation Account.
3. The receipts and expenditure on capital account shows
- (a) Amount at the commencement of the period.
  - (b) Amount received or spent during the period.
  - (c) Balance left at the end of a period.
  - (d) All of the above.
4. 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  $2\frac{1}{2}$  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.
5. 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



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## Financial Statements of Electricity Companies

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6. 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. 1,52,000. 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 (c); 3 (d); 4(a); 5 (c); 6(a); ]

### II. Short Answer Type Questions

7. 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

8. Explain 'receipt and payment on capital account' and 'general balance sheet' of a public utility.
9. State the advantages and disadvantages of Double Accounts System.

### IV. Practical Questions

10. The following balances are drawn from the books of an Electricity Supply Company for the year ended 31st December, 2005. Finalize the accounts following double accounts system (you may ignore the requirements of the Indian Electricity Rules, 1956).

<i>Sale of Electricity :</i>	<i>Rs.</i>
Domestic	75,20,000
Commercial	1,80,12,000
<i>Misc. Revenues :</i>	
Meter Rent	1,88,000
Service Connection Fees	1,75,000
Public Lighting Maintenance	2,80,000
<i>Other Revenues :</i>	
Sale of Stores	50,000
Repair of Electrical Apparatus	40,000
<i>Maintenance Expenses :</i>	
Salaries	78,40,000



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Operations and Maintenance of High Voltage Distribution	40,12,000
Operation and Maintenance of Medium and Low Voltage Distribution	36,40,000
Public Lighting	12,17,000
Consumers' Servicing	50,000
General Establishment Charges	2,85,000
<i>Sale of Electricity :</i>	
Interest	12,10,000
Bad Debts	80,000
Management Charges	4,80,000
<i>Assets as on 1-1-2005</i>	
Distribution Plant - High Voltage	1,80,50,000
Distribution Plant - Medium and Low Voltage	90,90,000
Public Lighting	40,00,000
General Equipment	50,00,000
<i>Share Capital :</i>	
10,00,000 equity shares of Rs. 10 each	1,00,00,000
Government Grant	10,00,000
Consumers' Contribution for Service Line	50,00,000
Loan	2,40,00,000
Reserve	40,50,000
<i>Capital Expenditure During 2005 :</i>	
High Voltage Distribution Plant	14,00,000
Medium and Low Voltage Distribution Plant	15,00,000
<i>Loan raised during 2005 :</i>	
10% Electricity Board	25,00,000
<i>Other Assets and Liabilities as on 31-12-2005 :</i>	
Sundry Creditors	15,22,000
Sundry Debtors	27,36,000
Cash at bank	62,97,000
Investments	82,50,000
Charge Depreciation @ 5% on all assets.	



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## Financial Statements of Electricity Companies

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11. 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.
12. 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 -2:SOME 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.

**2.1 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.

**2.2 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,



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## Financial Statements of Electricity Companies

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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.

### 2.3 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



## Advanced Accounting

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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



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## Financial Statements of Electricity Companies

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- (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].

### 2.4 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.

**2.5 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



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## Financial Statements of Electricity Companies

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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.

### 2.6 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.

### 2.7 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

## **2.8 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



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## Financial Statements of Electricity Companies

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- (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 3: ACCOUNTS AND AUDIT**

**3.1 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.

**3.2 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



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## Financial Statements of Electricity Companies

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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.

### 3.3 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.

### 3.4 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.



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## Financial Statements of Electricity Companies

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### 3.5 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
    - Total kW
  - (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





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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 :



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## Financial Statements of Electricity Companies

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- (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).



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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.



## Financial Statements of Electricity Companies

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 Licensees other than Local Authority Licensees)*

Description of Capital	Balance at the beg- inning 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.*



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### *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)'.



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**Financial Statements of Electricity Companies**

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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	Period of payment		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	
		Rate %	From To							
1	2	3	4	5	6	7	8	9	10	11

Total Loans Raised For  
The Electrification  
Scheme



## Advanced Accounting

### No. I A (2) Statement of Loan and Other Capital for the Year Ended 31st March 20—

Particulars	Balance at the begin- ning of the year	Received during the year	Redeemed during the year	Balance at the end of the year	Remarks
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)



## Financial Statements of Electricity Companies

### 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.





## Advanced Accounting

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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.



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## Financial Statements of Electricity Companies

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*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.



## Advanced Accounting

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- (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.



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## Financial Statements of Electricity Companies

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### 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.



## Advanced Accounting

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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 beginning of the year	Written down cost of assets retired during the year vide col. 4 St.II less	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-	Annual instalment written-off during the year vide col. 7 Statement VI	Balance of written-down cost at the end of the year



## Financial Statements of Electricity Companies

	column 8 Statement V					cies Reserve" Account vide col. 4 of Statement VI		
-	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.



## Advanced Accounting

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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



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## Financial Statements of Electricity Companies

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### 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.





## Advanced Accounting

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- (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.



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## Financial Statements of Electricity Companies

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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.



## Advanced Accounting

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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



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## Financial Statements of Electricity Companies

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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,



## Advanced Accounting

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- 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



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## Financial Statements of Electricity Companies

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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.



## Advanced Accounting

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- (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.



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## Financial Statements of Electricity Companies

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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 licensee 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.





## Advanced Accounting

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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.



## Financial Statements of Electricity Companies

### 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	annum provided	of dep-	during the	of accr-	of arrears		
in groups	Depreciation	of Dep-	the balance for the	reciation	year, vide	column 3	ued dep-	of depre-		
as per	brought for-	reciation	at	the year	written	Statement	carried	carried	Remarks	
Statement	ward from	brought for-	ing of the	off during	the year	II-A	over to	over to		
II	last account	ward from	Sixth Sche-	the year	Electricity	(Supply)	out	account		
		last account	dule to the	Act, 1948						
(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	.....	....	.....	....	.....	....	.....	....	.....
	<b>TOTAL</b>	.....	....	.....	....	.....	....	.....	....	.....

*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.



## Advanced Accounting

2. A sum of Rs.....from the accruals in the depreciation account has been invested in pursuance of the provisions of Paragraph XVII (l)(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	during the year	the year					Withdrawals during the year		
Particulars	Balance	Appropri-	Additions	Total	Instalment	Expenses	Total	Balance	Remarks	
	at the	ation during	under para-		under sub-	and/or		at the end		
	begin-	the year	graph IX of		para (3) of	compensation		of the		
	ning of		the Sixth		paragraph	under para-		year		
	the year		Schedule		VII of the	graph V of				
			of the elec-		Sixth Sche-	the Sixth				
			tric(Supply)		dule of	Schedule				
			Act, 1948		the Electric	to the Ele-				
			vide		(Supply) Act,	tric (Supply)				
			Col. 6		Statement					
			statement		II-A.					
			II-A		1948	vide Act, 1948				
					Co. 7					
					Statement					
					II-A.					
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



## Financial Statements of Electricity Companies

(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 year	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



## Advanced Accounting

### No. X Statement of net Revenue and Appropriations Account for the Year Ended 31st March, 20—

Correspond- ing figures of previous year	Particulars	Amount	Correspond- ing 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.		4.	By other receipts (non-operating) <i>e.g.</i> rents :	
	(b) Instalment of redemption of loan capital as per col 8 of St IA(1).			Less outgoings not otherwise provided for transfer fee etc. (to be specified).	
	(c) General rates.		5.	By Balance of loss carried over.	
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.				



## Financial Statements of Electricity Companies

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 over-drafts etc.
  - (d) Dividends on preference share capital.
  - (e) Dividends on ordinary share capital.
- To balance of profit 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.	
	<b>Reserves and Surplus</b>			Less: Accumulated provisions for depreciation. Statement V.	
	2. Non-statutory Reserve.			<b>Net Block</b>	
	3. Contingencies Reserve Fund as per Statement VI.			2. Balance of written down cost of obsolete, inadequate etc., assets, Statement II A.	
	4. Tariffs & Dividends Control Reserve as per Statement VII.			<b>Current Assets</b>	
	5. Consumers' Rebate Reserve as per Statement VIII.			3. Capital works in progress.	
	6. Special appropriations (as Per- mitted by the State Government) reserve as per Statement IX.			4. Stores and materials in hand :	
	7. Balance of Net Revenue and Ap- propriations Account as per State-			(a) Fuel-Coal and/or oil etc. at cost	
				(b) General Stores at or below cost	
				5. Debtors for amounts paid in	



## Advanced Accounting

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- ment X.
- Current Liabilities and Provisions at cost.
8. Balances due on construction of Plant, Machinery, etc.
  9. Creditors on open accounts (as per schedule attached).
  10. Consumers' security deposits.
  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.
- advance on account of contracts.
6. Sundry debtors for electricity supplied
  7. Other debtors (as per schedule attached,
  8. Accounts receivable (to be specified)
  9. Investments in statutory securities at cost
    - (a) Contingencies Reserve Fund investment,  
(Market value on closing date).
    - (b) Depreciation Reserve Fund investment.  
(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.



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## Financial Statements of Electricity Companies

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### Self-examination questions

1. Briefly explain the general principles of finance, audit and forms of financial statements of State Electricity Board.
2. Make a critical assessment of the structure of financial statements of an Electricity Supply Company.





**UNIT-4: 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.

**4.1 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.

**4.2 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.



### 4.3 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);



## Advanced Accounting

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*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 licensee 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;



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## Financial Statements of Electricity Companies

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- (v) interest on loan taken from organisations or institutions approved by the State Government;
- (vi) interest on debentures issued by the licensee;
- (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.

#### **4.4 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 2005 :

	<i>Rs.</i>
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



## Financial Statements of Electricity Companies

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

<i>Capital Base :</i>		<i>Rs.</i>
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		<u>10,00,000</u>
	<i>Rs.</i>	2,35,00,000
<i>Less :</i> 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	<u>5,00,000</u>	<u>1,81,00,000</u>
Capital Base		<u>54,00,000</u>
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	<u>35,000</u>	
	<u>6,38,000</u>	

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.



## Advanced Accounting

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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, 2006 and bearing in mind the provisions of the Electricity (Supply) Act, 1948 indicate the disposal of profit of E.E.C. Limited :

	<i>Rs.</i>
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, 2006.

	<i>Rs.</i>
Capital Base :	
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	<u>38,00,000</u>



## Financial Statements of Electricity Companies

	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	<u>2,20,000</u>
Capital Base	<u>1,92,82,000</u>
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	<u>2,70,000</u>
	<u>11,18,400</u>
<b>Surplus and its disposal</b>	
Profit	19,10,100
Less: Debenture interest	<u>7,50,000</u>
	11,60,100
Less: Reasonable return	<u>11,18,400</u>
Surplus	<u>41,700</u>
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	<u>13,900</u>
	<u>41,700</u>

### Illustration 3

The following balances have been extracted, at the end of 2005 from the books of an Electricity company :

	<i>Rs.</i>		<i>Rs.</i>
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		Intangible assets	8,00,000





## Advanced Accounting

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Invested in 7% State Loan	12,00,000	Tariffs and Dividends	
Loan from State Electricity Board	25,00,000	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 2005. 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

<i>Capital Base:</i>	<i>Rs.</i>	<i>Rs.</i>
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	<u>12,00,000</u>	
		2,83,00,000
<i>Deduct :</i>		
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	<u>10,00,000</u>	<u>1,33,00,000</u>
Capital		<u>1,50,00,000</u>
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		



## Financial Statements of Electricity Companies

and Development Reserve (Rs. 53,00,000)	26,500
	<u>23,06,500</u>
<b>Surplus and its disposal</b>	
Clear Profit	<u>28,00,000</u>
Surplus 28,00,000 — 23,06,500	4,93,500
Less: 20% of Reasonable Return	<u>4,61,300</u>
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	<u>1,72,987</u>
	<u>4,61,300</u>
	<i>Rs.</i>
Total amount at the disposal of the company	
(a) Amount of Reasonable Return	23,06,500
(b) Share in surplus	<u>1,15,325</u>
	<u>24,21,825</u>

### Illustration 4

The following balances relate to an electricity company and pertain to its accounts for the year ended 31st December, 2005 :

	<i>Rs.</i>
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



## Advanced Accounting

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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

<i>Capital Base :</i>	<i>Rs.</i>
(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)	<u>20,00,000</u>
	2,43,00,000

<i>Less :</i>	<i>Rs.</i>
(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	<u>10,00,000</u>
	<u>2,09,00,000</u>
	<u>34,00,000</u>

<b>Reasonable Return</b>	<i>Rs.</i>
(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



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## Financial Statements of Electricity Companies

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(v) 1/2% Balance of Development Reserve	<u>5,000</u>
	<u>6,64,000</u>
Disposal of Surplus	
Post tax profit	9,00,000
Reasonable Return	<u>6,64,000</u>
Surplus	2,36,000
Excess upto 20% of Reasonable Return	<u>1,32,800</u>
Amount refundable to consumers-credit to Consumers Benefit Account	<u>1,03,200</u>
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	<u>49,800</u>
	<u>1,32,800</u>
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)	<u>6,97,200</u>
	<u>9,00,000</u>

### 4.5 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.



#### 4.6 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.

#### 4.7 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, 2006 is as below:

<i>Particulars</i>	<i>(Rs. '000)</i>	
	<i>Dr.</i>	<i>Cr.</i>
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	



## Financial Statements of Electricity Companies

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		<u>60,50</u>
	<u>859,20</u>	<u>859,20</u>

During 2005-06, 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, 2006.



**Solution**

**Statement I**

**Statement of Share and Loan Capital for the year ended 31st March, 2006**

(Rs. '000)

<i>Description of Capital</i>	<i>Balance at the beginning of the year</i>	<i>Receipts during the year</i>	<i>Redeemed during the year</i>	<i>Balance at the end of the year</i>
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
	<u>325,00</u>	<u>50,00</u>	<u>50,00</u>	<u>325,00</u>
B. Capital Reserve	25,10	—	—	25,10
C. Loan Capital :				
15% Debentures	123,50	—	—	123,50
16% Term Loan	76,50	—	—	76,50
	<u>200,00</u>			<u>200,00</u>
D. Other capital	—	—	—	—
Total Capital raised and appropriated (A + B + C + D)	<u>550,10</u>	<u>50,00</u>	<u>50,00</u>	<u>550,10</u>



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**Financial Statements of Electricity Companies**

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Statement II  
Statement of Capital Expenditure  
for the year ended 31st March, 2006

<i>Particulars</i>	<i>(Rs. '000)</i>			
	<i>Balance at the beginning of the year</i>	<i>Additions during the year</i>	<i>Retire- ments dur- ing the year</i>	<i>Balance at the end of the year</i>
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	<u>285,29</u>	—	—	<u>285,29</u>
	<u>487,56</u>	<u>35,65</u>	—	<u>523,21</u>
D. Internal Combustion Power Plant	—	—	—	—
E. Transmission Plant: Transformers	82,20	—	—	82,20
F. Distribution Plant (H.V.)				
Mains	22,62	—	—	22,62
Meters	<u>15,75</u>	—	—	<u>15,75</u>
	<u>38,37</u>			<u>38,37</u>
G. Distribution Plant (L.V.)		—	—	
H. Public Lighting :				
Public Lamps	<u>15,20</u>	—	—	<u>15,20</u>
I. General Equipments :				
Electrical Instruments	7,65	—	—	7,65
Office Furniture	<u>12,25</u>	—	—	<u>12,25</u>
	<u>19,90</u>			<u>19,90</u>
Total Capital Assets in use	<u>655,75</u>	<u>35,65</u>		<u>691,40</u>





**Statement XI**  
**General Balance Sheet as on 31st March, 2006**

		(Rs '000)	
<i>Correspon-Particulars</i>	<i>Amount</i>	<i>Correspon- Particulars</i>	<i>Amount</i>
<i>ding figure</i>		<i>ding figure</i>	
<i>of previous</i>		<i>of previous</i>	
<i>year</i>		<i>year</i>	
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	<u>129,08</u>
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	<u>16,27</u>
	<u>730,12</u>		<u>730,12</u>

**Illustration 6**

Vidyut Electric Supply Co. Ltd., gives you the following extract from its trial balance as on 31st March, 2006 :

	<i>Dr.</i>	<i>Cr.</i>
	<i>Rs.</i>	<i>Rs.</i>
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 :	<i>Rs.</i>	
Buildings	22,500	
Plant & Machinery	7,500	



## Financial Statements of Electricity Companies

Transformers	90,000	
Mains and services	5,10,000	
Lorries	<u>18,000</u>	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 :	<i>Rs.</i>	
Domestic	25,75,000	
Industrial	<u>1,49,00,000</u>	
		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 1-4-2005)		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)	<i>Rs.</i>	17,25,000
(b) Provisions for taxation	<i>Rs.</i>	22,80,000
(c) Transfer to Contingency reserve	<i>Rs.</i>	2,25,000
(d) Transfer to Development reserve	<i>Rs.</i>	1,20,000
The amount of reasonable return may be presumed to be Rs. 11,94,000.		



## Advanced Accounting

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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, 2006**

<i>Particulars of Revenue</i>	<i>Corresponding amount for the previous year Rs.</i>	<i>Amount for the current year Rs.</i>
A. Net revenue by sale of electricity :		
Domestic		25,75,000
Industrial		1,49,00,000
Public lighting		<u>22,500</u>
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	<u>15,000</u>	
Total other revenues		<u>52,500</u>
Total operating revenues (A + B + C)		1,76,55,000
Less: Total operating expenses as per Schedule IV		<u>1,32,97,500</u>
Net surplus carried to Net Revenue Account — Statement X		<u>43,57,500</u>

\* Misc. receipts are considered to be operating in nature.



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**Financial Statements of Electricity Companies**

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Statement IV  
Statement of Operating Expenses  
For the year ended 31st March, 2006

<i>Particulars of Revenue</i>	<i>Corresponding amount for the previous year Rs.</i>	<i>Amount for the year Rs.</i>
A. Hydraulic Power Generation		—
B. Steam Power Generation		—
C. Internal Combustion Power Generation		—
D. Power purchased		<u>62,25,000</u>
Total production expenses		<u>62,25,000</u>
E. Transmission :		
(a) Operation and maintenance :		
Wages of substation labour		
Repairs and maintenance :		3,40,000
Buildings		22,500
Plant & Machinery		7,500
Transformers		<u>90,000</u>
		4,60,000
(b) Depreciation :		
Building, Plant and Transformer		<u>9,25,000</u>
Total Transmission expenses		<u>13,85,000</u>
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		<u>18,000</u>
		18,28,000
(b) Depreciation		<u>8,00,000</u>
Total Distribution Expenses		<u>26,28,000</u>



## Advanced Accounting

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	<u>1,50,000</u>
	Total general establishment charges	<u>29,14,000</u>
L.	Other charges :	
	Interest on consumers' security deposits	<u>1,20,000</u>
		<u>1,20,000</u>
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, 2006

<i>Corres- ponding figure of previous year</i>	<i>Particulars</i>	<i>Amount</i>	<i>Corres- ponding figure of previous year</i>	<i>Particulars</i>	<i>Amount</i>
		<i>Rs.</i>			<i>Rs.</i>
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'				



## Financial Statements of Electricity Companies

Rebate Reserve	63,150	
To Interest on Loan	3,52,500	
To Balance of Profit carried over	<u>13,29,050</u>	
	<u>44,32,850</u>	<u>44,32,850</u>

### Workings:

(a) Calculation of clear profit :

	<i>Rs.</i>	<i>Rs.</i>
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	<u>1,20,000</u>	<u>29,77,500</u>
Clear profit		<u>13,80,000</u>

(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	<u>59,700</u>	<u>59,700</u>
Whichever is less, is at the disposal of the undertaking		<u>1,26,300</u>
1/2 of above to Tariff and Dividend control reserve		63,150
Balance available for benefit of consumers		<u>63,150</u>
		<u>1,26,300</u>

### Illustration 7

From the balances extracted from the books of the City Electric Supply Company Limited for the year ended 31st March, 2006, 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, 2006 :



## Advanced Accounting

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	<i>Rs.</i>
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 :	



## Financial Statements of Electricity Companies

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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
Insurance 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, 2006**

<i>Description of Capital</i>	<i>Balance at the beginning of the year</i>	<i>Receipts during the year</i>	<i>Redeemed during the year</i>	<i>Balance at the end of the year</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
A. Share Capital :				
Authorised Capital				
2,00,000 equity shares				
of Rs. 100 each	<u>2,00,00,000</u>			
Issued & paid up capital				
40,000 equity shares of				
Rs. 100 each	<u>40,00,000</u>	-	-	<u>40,00,000</u>
Total Paid up capital	<u>40,00,000</u>			<u>40,00,000</u>
B. Capital Reserve	1,60,000	-	-	1,60,000
C. Loan Capital				
Mortgage Debentures	1,28,00,000	-	-	1,28,00,000
IFCI Loan	<u>8,00,000</u>	-	-	<u>8,00,000</u>
Total Loan Capital	<u>1,36,00,000</u>			<u>1,36,00,000</u>
D. Other Capital	-	-	-	-
Total Capital raised and appropriated				
(A + B + C + D)	1,77,60,000	-	-	1,77,60,000



## Financial Statements of Electricity Companies

### Statement II Statement of Capital Expenditure For the Year ended 31st March, 2006

<i>Particulars</i>	<i>Balance at the beginning of the year</i>	<i>Additions during the year</i>	<i>Retirements during the year</i>	<i>Balance at the end of the year</i>
	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>	<i>Rs.</i>
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.	<u>40,50,000</u>	<u>9,50,000</u>	-	<u>50,00,000</u>
	<u>1,25,70,000</u>	<u>20,30,000</u>		<u>1,46,00,000</u>
D. Internal Combustion Power Plant	-	-	-	-
E. Transmission Plant	-	-	-	-
F. Distribution Plant (HV) :				
Mains	6,60,000	3,40,000		10,00,000
Accumulators	<u>30,520</u>	<u>10,400</u>		<u>40,920</u>
	<u>6,90,520</u>	<u>3,50,400</u>		<u>10,40,920</u>
G. Distribution Plant (L.V.)	-	-	-	-
H. Public Lighting				
Public Lamps	<u>2,14,000</u>	<u>26,000</u>	-	<u>2,40,000</u>
I. General Equipments				
Loose Tools & Plant	80,760	7,000	-	87,760
Electrical Instruments	22,000	-	-	22,000
Office Furniture & Fittings	<u>9,800</u>	-	-	<u>9,800</u>
	<u>1,12,560</u>	<u>7,000</u>		<u>1,19,560</u>
Total Capital Assets in use	<u>1,35,87,080</u>	<u>24,13,400</u>		<u>1,60,00,480</u>



## Advanced Accounting

### Statement III Statement of Operating Revenues for the year ended 31st March, 2006

<i>Particulars of Revenue</i>	<i>Corresponding amount for the previous year. Rs.</i>	<i>Amount for the current year Rs.</i>
A. Net revenue by sale of electricity :		
Domestic or Residential		12,60,000
Industrial		10,18,000
Public Lighting		<u>2,50,000</u>
Total revenue by sale of electricity		<u>25,28,000</u>
B. Miscellaneous revenue from consumers :		
Meter and other rents		68,200
C. Other revenues :		
Sale proceeds of scrap		400
Cash discount on purchases		<u>2,800</u>
Total other revenues		<u>3,200</u>
Total operating revenues (A + B + C)		25,99,400
Less: Total operating expenses as per Schedule IV		<u>18,14,120</u>
Net Surplus carried to Net Revenue Account — Statement X		<u>7,85,280</u>



## Financial Statements of Electricity Companies

### Statement IV Statement of Operating expenses for the year ended 31st March, 2006

<i>Particulars of expenses</i>	<i>Corresponding amount for the previous year Rs.</i>	<i>Amount for the Current year Rs.</i>
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		<u>1,33,880</u>
Total operations		<u>7,78,240</u>
(b) Maintenance :		
Repairs & Maintenance :		
Building		11,100
Plant		<u>20,100</u>
Total Maintenance		<u>31,200</u>
(c) Depreciation :		
Building, Plant etc.		<u>3,60,000</u>
Total generation expenses (a + b + c)		<u>11,69,440</u>
C. Internal Combustion Power Generation		—
D. Power Purchased		—
Total Production Expenses (A + B + C + D)		<u>11,69,440</u>
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		—
		<u>1,46,560</u>



## Advanced Accounting

G. Distribution (M&LV)	—
H. Public Lighting :	
(a) Operation & maintenance :	
Attendance & Repairs	65,000
Renewals	<u>22,000</u>
	<u>87,000</u>
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	<u>19,200</u>
Total general establishment charges	<u>3,71,120</u>
L. Other charges	—
M. Management expenses	
Directors remuneration	<u>40,000</u>
Total operating expenses transferred to Statement III	<u>18,14,120</u>

### Statement X

#### Statement of Net Revenue and Appropriations Account for the year ended 31st March, 2006

Corresponding figure of previous year	Particulars	Amount	Corresponding figure of previous year	Particulars	Amount
Rs.		Rs.	Rs.		Rs.
1	2	3	4	5	6
	To Contribution towards contingency reserve	80,000		By Balance of profit brought forward	16,080



## Financial Statements of Electricity Companies

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	<u>200</u>
	<u>8,07,560</u>		<u>8,07,560</u>

### Statement XI

#### General Balance Sheet as on 31st March, 2006

<i>Corresponding figure of previous year</i>	<i>Particulars</i>	<i>Amount</i>	<i>Corresponding figure of previous year</i>	<i>Particulars</i>	<i>Amount</i>
<i>Rs.</i>		<i>Rs.</i>			<i>Rs.</i>
	Capital raised & appropriated (Statement-I)	1,77,60,000		Capital amount expended on works in use : (Statement - II)	1,60,00,480
	Reserve and surplus :			Less: Depreciation fund	<u>6,80,000</u>
	Contingency reserve	2,80,000			1,53,20,480
	Balance of Net Revenue A/c - Statement X	45,560		Current Assets :	
	Current Liabilities & Provisions :			Stock in hand	12,64,000
	Creditors	2,75,010		Sundry Debtors	14,60,000
	Proposed dividend	1,60,000		Contingency	
				Reserve Investment	2,00,000
				Bank balance	1,80,570
				Cash in hand	79,520
				Prepaid expenses	<u>16,000</u>
		<u>1,85,20,570</u>			<u>1,85,20,570</u>

#### 4.8 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.



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## Financial Statements of Electricity Companies

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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  $\frac{1}{2}$  per cent on loans advanced by the Electricity Board.
  - (b) An amount equal to  $\frac{1}{2}$  per cent on the amount raised by the issue of debentures.
  - (c) An amount equal to  $\frac{1}{2}$  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**

5. 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.
6. 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.
7. An electricity company earned a profit of Rs. 18,50,000 during 2004-05. 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 ?
8. From the following details of Tata Power , you are required to draw the capital account and general balance sheet as at 31<sup>st</sup> March, 2006 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 31.3.2005: Machinery RS. 3,00,000 Building RS. 2,00,000;  
Additions during the year: Machinery RS. 60,000; Building Rs. 50,000.

Depreciation fund: Machinery Rs. 70,000; Building Rs. 50,000.

Profit and loss account RS. 40,000.