Lesson -1

INTERNAL RECONSTRUCTION

1.0 Objectives

After going through this chapter, the student will be able to:

1. appreciate the need for reconstruction of companies;

2. explain various schemes of internal reconstruction and

3. understand accounting treatment of various schemes of internal reconstruction.

1.1 Introduction

A company might have suffered huge losses in the past or might have the problem of over capitalization or might have over valued its fixed assets because of inadequate provision for depreciation. Such a company faces the threat of going onto liquidation either voluntarily or because of a petition by any of its creditors or debenture holders. In these situation companies have three options: a)to liquidate the company (Liquidation) b) to reconstruct Externally (External Reconstruction) and c) to reconstruct internally (Internal Reconstruction)

1.2 Meaning of Internal Reconstruction

Internal Reconstruction is an arrangement made by companies whereby the claims of shareholders, debenture holders, creditors and other liabilities are altered/ reduced, so that the accumulated losses are written off, assets are valued at its fair value and the balance sheet shows the true and fair view of the financial position.

1.3 Schemes of Internal Reconstruction

A company can reconstruct its internal affairs in the following ways:

i. Reduction of Share Capital and other Liabilities
ii. Re-organization or Alteration of Share Capital
iii. Variation of shareholders rights
iv. Compromise / Arrangement
v. Surrender of shares

1.2.1 Reduction of Share Capital and other Liabilities

Reduction of share capital is an arrangement under which the capital of the shareholders and sometimes even the claims of the creditors and debenture holders are reduced. The amount made available by way of capital reduction is utilized in writing off the fictitious assets, accumulated losses, and the overvalued portion of the other assets.

A corporate sector unit can reduce its paid-up capital if

(a) It is authorized by its articles

(b) A special resolution is passed and

(c) A sanction of the court is obtained

Methods of Reduction in Capital

Following are the methods of reductions of capital:

1. **Reduction in paid up value only**

Here the nominal value of shares remains same only paid up is reduced.

Example 1. The shareholders may agree to reduce the paid up value of Rs.100 into paid up value of Rs.10 by making a sacrifice of Rs. 90 per share. For this transaction the following journal entry will executed:

Sr. No	***Particular***	***Dr***	***Cr***
1	Share capital Account Dr (90X No. of shares)	90	
	To Capital Reduction Account (90X No. of shares)		90

2. **Reduction in both Nominal and Paid up value**

In this case both the paid up capital and nominal value are reduced. If we consider the above example, then the following journal entries will be passed:

Sr. No	***Particular***	***Dr***	***Cr***
1	Share Capital Account Dr (100 X No. of shares)	100	
	To Capital Reduction Account (90 X No. of shares)		90
	To Share Capital A/c(10 X number of shares)		10

Procedure for Reduction of Share Capital

Following is the procedure for the reduction of share capital of company:

Board Meeting

A Board Meeting shall be convened to approve the scheme of reduction of share capital and to approve the draft notice of the general meeting. Because as per Companies' Act, 1956 power to reduce share capital shall have been authorized by the article of association. In the non existence of such provision, the articles should first be altered.

General Meeting of Shareholders

In the case of a listed company the general meeting shall be held to pass a special resolution for reduction of share capital. Notice of the general meeting shall be issued to members and other eligible person at least 21 clear days' before the date of general meeting. It also compulsory for a listed company to Send 3 copies of the notice of the general meeting to stock exchange. In case of a listed company, send a copy of the proceedings of the general meeting to the stock exchange Inform the stock exchange by letter or telegram regarding the reduction of share capital as decided by the Board; [Clause 22(c) of listing agreement].

Form No.23 of Companies General Forms and Rules, all along with a copy of the special resolution, shall be filed with Registrar of Companies within 30 days from the date of resolution together with the filing fee.

Court

A petition shall be filed in the court, for confirmation of the reduction of share capital in (Form No.18) of the Companies Court Rules together with the following documents:

a) Form No.19 of the Companies Court Rules;

b) Affidavit in Form No.3 of the Companies Court Rules;

c) Attested copy of articles and memorandum;

d Attested true copy of the notice calling the meeting;

e) Attested true copy of the special resolution and minutes regarding the reduction of share capital;

f) Most recent audited Balance Sheet and Profit and loss account;

g) Required Court fee as prescribed by the rules of the concerned High Court.

The petition shall be advertised in the required Form No.5 of the Companies Court Rules at least 14 days before the date of hearing fixed by the Court in the official Gazette of the State and in leading English and one vernacular daily newspapers circulating in the State in which the registered office of the company is situated. In case of a listed company, send three copies of the advertisement to the stock exchange.

If the proposed reduction involves either diminution of liability in respect of unpaid share capital or payment to any shareholder of any paid-up share capital, the method laid down in Rules 48 to 59 of Companies (Court) Rules, 1959 shall also be comply with by filing Form Numbers 21 to 29 of the supposed rules as under:

a) A list of creditors in Form No.21 of the Companies Court Rules duly certified by an affidavit in Form No.22 of the said regulations shall be filed;

b) Issue notice in Form No.23 of the Companies Court Rules to each of the creditors as per the above list through prepaid registered post;

c) The notice and the list of creditors in Form No.24 of the Companies Court Rules, shall be advertised within 7 days from the date of filing, in the Official Gazette of the State in which the registered office of the company is situated;

In case of a listed company, send three copies of the above advertisement to the Stock Exchange;

d) An affidavit proving despatch and publication of the notices mentioned in (b) and (c) above shall be filed with the Court in (Form 25) of the Companies Court Rules;

e) A Statement signed by the company's advocate and verified by the company stating the result of the notices mentioned in (b) and (c) above accompanied by an affidavit in (Form 26) of the Companies Court Rules shall be filed within the time fixed by the Court;

f) Serve notice in Form No. 27 of the Companies Court Rules in respect of creditors, doubtful by the company at least 4 clear days before the date of hearing fixed by the Court if the company contends that a person is not entitled to be entered in the list of creditors in respect of any debts or claim, whether admitted or not, or if any debt or claim, the particulars of which are so sent in, shall not be admitted by the company at its full amount, then, and in every such case, unless the company is willing to set apart and appropriate in such manner as the Judge shall direct, the full amount of such debt or claim, the company shall, if the Judge thinks fit so to direct, sent to the creditor a notice in Form No. 27, that he is required to come in and establish his title to be entered on the list, or as the case may be, to come in and prove such debts or claim or such part thereof as is not admitted by the company on the day fixed by the Judge. Such notice Such notice shall be served not less than four clear days before the date fixed by the Judge

g) File the certification by company's advocate regarding the result of the settlement of list of creditors;

h) Advertise the notice regarding the date of hearing fixed for the petition, in (Form 29) of the Companies Court Rules in specified newspapers and within prescribed time as may be directed by the Court.

In case of a listed company, send three copies of the above advertisement to the stock exchange. On passing of the order by the High Court, reason for the reduction of capital shall be published, if so directed by the High Court.

Notice of the Court's order shall be delivered to the Registrar of Companies in Form No. 21 of Companies General Rules and Forms, within 30 days of the receipt of the Court's order, after paying the requisite fee.

A certified copy of the High Court's order and minutes shall be delivered to the Registrar of Companies. The Registrar shall register the copy of the order and minutes and certify the same under his own hand writing, whereupon the reduction of capital becomes successful. [Section103].

The notice of registration shall be published in the manner directed by the High Court in the Companies Court Rules. [Section 103(3)].

In case of a listed company, send three copies of the above advertisement to the stock exchange. [Clause 31(e) of listing agreement].

Steps to Be Taken Subsequent to Reducing the Capital

Once the reduction of capital has completed, steps given below shall be taken:

a) Required alteration shall be made in all copies of memorandum and articles;

b) Surplus share capital shall be paid off;

c) Alteration in Share certificates shall be made in order to reflect the reduction in liability in respect of uncalled or unpaid capital;

d) Excess paid-up capital, shall be cancelled;

e) If so directed by the High Court, the words 'and reduce' shall be added to the company's name for the period specified in the order. [U/s 102].

In case of a listed company, send six copies including a certified copy of the alterations to the memorandum and articles to the stock exchange.

1.2.2 Re-organization or Alteration of Share Capital

Alteration/ Re-organization of share capital refer to the arrangement of the capital of the company and include the following**:**

a. Increase the share capital by making fresh issue of shares

b. Decreasing the share capital by cancelling the unissued shares.

c. Conversion of shares into stock and vice -versa

d. Consolidation of shares of smaller amounts into shares of larger amounts

e. Sub-division of shares of larger amounts into share of smaller amounts. A company can make alteration in its share capital if it is authorized by its Articles of Association.

1.2.3. Variation of Shareholders Rights

When a company has issued different types of shares with different types of rights regarding voting and right of dividend etc, such right may be changed in any manner and considered as part of internal reconstruction. For example, company may change rate of dividend on preference shares and convert cumulative preference shares into non cumulative preference shares without changing amount of share capital by passing the following journal entries.

Journal Entries

Sr. No	*Particular*	*Dr*	*Cr*
1	On change in rate of dividend		
	(Old)% cum Preference share capital A/c Dr		
	To (New)% cum Preference share capital A/c		
2	On conversion of Cumulative pref. shares into non cumulative		
	--% cum Pref. Share capital a/c Dr		
	To Non- Cum Pref. Share Capital Account		

1.2.4. Compromise or Arrangement

Compromise or arrangement is an agreement between companies and its members and outsiders when a company face financial problem. It may be agreement between company and shareholders, debenture holders or creditors etc or among all. Accounting treatment for the arrangement may be understood by the following entries:

Journal Entries

Sr. No	***Particular***	***Dr***	***Cr***
1	When equity shareholders give up right to accumulated reserves and profits		
	Reserve A/c Dr		
	To Reconstruction A/c		
2	Settlement with creditors in lesser amount than their actual claim		

Outside liabilities Dr(Amount of sacrifice)

Provision A/c (made by creditor, debenture holders etc)

To Reconstruction A/c

The methods of capital reduction can be well understood with the help of illustration given below:

Example: 2 The business of ATC Limited was being carried on continuously at losses. The following are the extracts from the balance sheet of the company as on 31st March, 2012:

Liabilities	Rs	Assets	Rs
30,000 Equity shares@ 10 each	3,00,000	Goodwill	50,000
2,000 8% cumulative preference shares of Rs 100	2,00,000	Plant	3,00,000
Securities Premium	90,000	Loose tools	10,000
Unsecured loan (from director)	50,000	Debtors	2,50,000
Sundry creditors	50,000	Stock	1,50,000
Outstanding expenses (including Remuneration 20,000)	70,000	Cash	10,000
		Bank	35,000
		Preliminary expenses	5,000
		Profit and Loss A/c	2,00,000
Total	**10,10,000**	**Total**	**10,10,000**

Note:

Dividends on cumulative preference shares are in arrears for 3 years.

The following scheme of reconstruction has been agreed upon and duly approved by court:

i) Equity shares to be converted into 1, 50,000 shares of Rs 2 each.

ii) Equity shareholders to surrender to the company 90% of their holdings.

iii) Preference shareholders agree to forego their right to arrears to dividends in consideration of which 8% preference shares are to be converted into 9% preference shares.

iv) Sundry creditors agree to reduce their claim by one fifth in consideration of their getting shares of Rs 35,000 out of surrendered equity shares.

v) Directors agree to forego the amount due on account of unsecured loan and directors' remuneration.

vi) Surrendered shares not otherwise utilised to be cancelled.

vii) Assets to be reduced as under:

Goodwill	50,000
Plant	40,000
Tools	8,000
Sundry Debtors	15,000
Stock	20,000

viii) Any surplus after meeting the losses should be utilised in writing down the value of the plant further.

ix) Expenses of reconstruction amounted to Rs 10,000.

x) Further 50,000 equity shares were issued to the existing members for increasing the working capital. The issue was fully subscribed and paid up.

xi) Authorised capital was suitably increased.

A member holding 100 equity shares opposed the scheme and his shares were taken over by a director on payment of Rs 1000 as fixed by the court.

You are required to pass the journal entries for giving effect to the above arrangement and also to draw up the resultant balance sheet of the company.

Solution:

Journal Entries

Particulars	Dr (Rs)	Cr (Rs)
Equity Share Capital (Rs 10) A/c Dr	3,00,000	
To Equity shares capital (Rs 2) A/c		3,00,000
(Being equity shares of Rs 10 each converted into equity shares of Rs 2 each converted equity shares of Rs. 2)		
Equity share capital (Rs 2) A/c Dr	2,70,000	
To Share surrendered A/c		2,70,000
(Being 90% of equity share surrendered)		
8% cumulative preference share capital A/c Dr	2,00,000	
To 9% Cumulative preference shares A/c		2,00,000
(Being 8% Cumulative preference shares converted into 9%)		
Shares surrendered A/c Dr	35,000	
To Equity shares capital (Rs 2) A/c		35,000
(Being 17500 equity shares out of surrendered issued to creditors for $1/5^{th}$ claim)		
Expenses of reconstruction A/c Dr	10,000	
To Cash		10,000
(Being expenses of reconstruction paid)		

Shares surrendered A/c Dr	2,35,000	
To Capital reduction A/c		2,35,000
(Being cancellation of remaining surrendered shares according to the scheme of reduction)		
Unsecured Loan A/c Dr	50,000	
Sundry creditors A/c Dr	60,000	
Outstanding A/c Dr	20,000	
To capital reduction A/c		1,30,000
(Being amounts sacrificed by various parties as per the reconstruction scheme transferred to capital reduction a/c)		
Capital reduction A/c Dr	3,65,000	
To Goodwill A/c		50,000
To Loose tools A/c		8,000
To Sundry debtors A/c		15,000
To Stock in trade A/c		20,000
To Profit and loss A/c		2,00,000
To Preliminary expenses A/c		5,000
To Expenses of reduction A/c		10,000
To Plant A/c		57,000
(Being expenses of reconstruction, various losses and amounts written off various assets debited to capital reduction account as per the scheme balance of the amount credited to plant)		
Bank A/c Dr	1,00,000	
To Equity share capital (Rs 2) A/c		1,00,000
(Being 50,000 equity shares of Rs. 2 each issued as fully paid)		

ATC Ltd (and Reduced)
Balance Sheet
as on 31 March 2012

Liabilities	***Rs***	***Assets***	***Rs***
Authorised:		Goodwill 50,000	Nil
1,50,000 equity shares @ 2	3,00,000	Less: Amount written off	
2000, 9 % preference shares2 100	2,00,000	50,0000	
		Plant 300,000	2,43,000
		Less: Amt written off 57,000	
82,500 equity shares @2 per share	1,65,000	Loose tools	2,000
2000, 9% preference shares @ 100	2,00,000	Stock in trade	1,30,000
Per share			
Securities premium	90,000	Sundry debtors	2,35,000
Sundry Creditors	2,40,000	Cash at Bank	1,25,000
Outstanding expenses	50,000	Cash in Hand	10,000
	7,45,000		**7,45,000**

1.2.5 Surrender of Shares: The shareholders are made to surrender their shares. These shares are then allotted to debenture holders and creditors in order to reduce their claim. The balance surrendered shares are then cancelled. The following journal entries will be passed for surrender of shares:

Journal Entries

Sr. No	*Particular*	*Dr*	*Cr*
1	On surrender of shares		
	Share capital A/c Dr		
	To Share surrendered A/c		
2	On reissue of surrendered shares		
	Share surrendered A/c Dr		
	To Share Capital Account		
3	On cancellation of surrendered shares		
	Share surrendered A/c Dr		
	To Capital Reduction A/c		

Example 3 The following information relates to Disappointed Ltd. as on 31^{st} December, 2010.

	(Rs)
2000 Equity shares @100	2, 00,000
1,000 6% Debentures @100 each	1, 00,000
Interest on debentures outstanding	12,000
Trade creditors	50,000
Fixed assets	2, 00,000
Current assets	65,000
Fixed assets revalued	96,000
Current assets revalued	48,000

The following scheme was duly agreed and approved by the court:

1. The shares were sub divided into shares of Rs. 5 each and 90 per cent of the shares were surrendered.
2. The total claims of debentures holders were reduced to Rs. 49,000 and in consideration of this, they were also allotted shares (out of the surrendered shares) amounting to Rs. 25,000.

3. The creditors agreed to reduce their claims to Rs. 30,000, 1/3 of which was satisfied by of equity shares out of those surrendered.
4. The shares surrendered but not reissued were cancelled.

You are required to draft the necessary journal entries.

Solution

Journal Entries

Date	*Particulars*	*Dr Rs.*	*Cr Rs.*
	Equity shares capital(Rs 100) Dr	2,00,000	
	To Equity share capital (Rs 5)		2,00,000
	Being sub division of equity shares of Rs 100 each into of Rs.5		
	Equity Share Capital A/c(Rs 5) Dr	1,80,000	
	To Shares surrendered A/c		1,80,000
	Being surrender of 90 per cent of equity shares		
	6 % Debentures A/c Dr	51,000	
	Outstanding interest on Debentures A/c Dr	12,000	
	To Capital Reduction A/c		63,000
	Being reduction in the claims of debentures holders to Rs. 49,000 as per the reconstruction scheme		
	Share Surrendered A/c Dr	35,000	
	To Equity Shares capital A/c		35,000
	Being allotment of equity shares of Rs. 25000		
	Sundry Creditors A/c Dr	30,000	
	To Capital Reduction A/c		30,000
	Being reduction of claim of creditors from Rs. 50,000 to Rs. 20,000.		
	Capital Reduction A/c Dr	2,38,000	
	To Profit and Loss A/c		97,000
	To Fixed Assets A/c		1,04,000
	To Current Assets A/c		17,000
	To Capital Reserve A/c		20,000
	Being writing down the value of different assets and the debit balance in the profit and loss account.		

1.4 Accounting Entries for Internal Reconstruction

The accounting entries for internal reconstruction are as follows:

Journal Entries

Sr. No.	*Particulars*	*Dr*	*Cr*
1.	For reduction of Equity Share Capital		
	(Old) Equity Share Capital Account Dr.		
	To (new) Equity Share Capital Account		
	To Capital Reduction Account		
2.	For reduction of Preference Share Capital		
	(Old) Preference Share Capital Account Dr.		
	To (new) Preference Share Capital Account		
	To Capital Reduction Account		
3.	For reduction of the amount due to debenture holders		
	Debenture holders Account Dr.		
	To Capital Reduction Account		
4.	For reduction of the amount due to Creditors		
	Creditors Account Dr.		
	To Capital Reduction Account		
5.	For appreciation in the value of Assets		
	Assets Account Dr.		
	To Capital Reduction Account		
6.	For the payment of Reconstruction expenses		
	Reconstruction Expenses Account Dr.		
	To Bank Account		
7.	For utilization of capital reduction account in writing off accumulated losses and various fictitious assets		
	Capital Reduction Account Dr.		
	To Profit and Loss account (loss)		
	To Preliminary Expenses		
	To Discount of issue of shares or debentures account		
	To underwriting commission account		
	To Advertising Suspense’s account		
	To Reconstruction Expenses account		
	To Good will account		
	To Patents or Trade Marks account		
	To Fixed assets account (over valued assets)		
	To Other assets account		
	To Capital Reserves account (if some balance is still)		

Example: 4 Consider the balance sheet of ABC Ltd. as on 31st Dec 2012.

Balance Sheet

as on 31st Dec.2012

Liabilities	***Rs***	***Assets***	***Rs***
Equity 400000@5	20,00,000	Local works	2000000
Pref, Capital 300000@5	15,00,000	Upcountry	1000000
10% A Debentures(secured by local works)	100,000	Investment of work comp Fund	35000
9% B Debentures (Secured by upcountry work)		Stock	1,15,000
Workmen comp. Fund		Debtors	50,000
Local 25000			
Upcountry 10000	35000		
Bank Overdraft	7,50,000	Preliminary Exp	12500
Creditor	2,00,000	Profit & Loss A/c	16,22,500
Total	**48,35,000**	**Total**	**48,35,000**

The following format of reconstruction was approved by all parties concerned:

1. The equity shares were reduced to 25 paisa per share.
2. The preference Share was reduced to Rs. 3.75 per share and the rate of dividend was reduced to 9%.
3. The debenture holders waived Rs. 42000 being interest due to them (included in creditors).
4. Director agreed to refund Rs. 50,000 fees which they had received. This amount was refunded by them in cash.
5. The B Debenture holders formed new company Ltd. to take over the upcountry works at Rs 500000. The price was settled by surrender of B Debentures and allotment of 25000 equity of Rs 10 Each as fully paid in New Co Ltd.
6. Investment was valued at Rs. 25000, stock at Rs. 25000, stock at Rs 50,000 and Debtors at Rs 40000. There was no actual liability to upcountry works employees. The assets were to be written down as above the fictitious assets were to be wiped off. Necessary reserves

were to be retained and the balance available was to be written off the book value of local works.

Prepare the necessary journal entries and Balance sheet Reddu Ltd. after giving effect of the above scheme.

Solution

Journal Entries

Sr. No.	***Particulars***	***Dr***	***Cr***
1.	Rs. 5 Equity Share Capital Dr	2000000	
	To Rs 0.25 Equity capital		1,00,000
	To Capital Reduction		19,00,000
2.	10% Pref. Share capital A/c Dr	15,00,000	
	To Rs. 3.75, 9 % Pref Share capital A/c		11,25000
	To Capital Reduction A/c		3,75,000
3	Sundry creditors A/c Dr	42,000	
	To Capital Reduction A/c		42,000
2	Bank a/c Dr	50,000	
	To Capital Reduction A/c		50,000
3	9% B Debenture a/c Dr	2,50,000	
	To 9% B Debenture holders A/c		2,50,000
4	9%, B Debenture Holders A/c Dr	5,00,000	
	To Upcountry Works		5,00,000
5	Investment in new Co. Dr	2,50,000	
	To 9% B Debenture Holders a/c		2,50,000
6	Workmen's Compensation Fund A/c Dr	10,000	
	To Capital Reduction A/c		10,000
	Capital Reduction A/c Dr	23,77,000	
	To Profit and Loss A/c		16,22,500

To Preliminary Expenses	12,500
To Upcountry Works	5,00,000
To Investment A/c	10,000
To Stock	65000
To Provisions for Doubtful Debt	10,000
To Local Works	1,57,000

ABC Ltd (After Reconstruction)
Balance Sheet
as on 31 Dec. 2012

Liabilities	***Rs***	***Assets***	***Rs***
Equity 400000@0.25	1,00,000	Local works	1843000
Pref, Capital 300000@3.75	11,25,000	Investment in New Co	2,50,000
10% A Debentures(secured by local works)	100,000	Investment of work comp Fund	25000
		Stock	50,000
Workmen Comp Fund	25,000	Debtors	40,000
Bank Overdraft	7,50,000	Cash & Bank	50,000
Creditor	158000		
Total	**22,58,000**	**Total**	**22,58,000**

Note: It has been assumed that the 5,000 shares in the New Co. Ltd are worth Rs. 2, 50,000 since that figure together with that of the amount of B Debenture Makes Rs. 500,000, the value of upcountry works.

1.5 Reconstruction Process

It has already been stated that Board of Directors of a company have to submit a reconstruction or reorganisation scheme to the Court for reconstructing the capital structure of a company. The method of preparation of such scheme is as follows:

Assumptions: Reconstruction Scheme should be based on the following assumptions:

1. Company will be in position to earn sufficient fund in future. Sufficient fund means that the profit will be available for payment of interest, dividend and future internal requirement for internal investment.
2. Scheme will have the approval of all the parties concerned.

3. Shareholders and Debenture holders are willing to provide extra funds.

1.6 Steps for Reconstruction

Some steps should be taken for drafting of a reconstruction scheme.

1. **Estimation of loss**

Estimating loss due to written off is the first step to be taken to prepare a reconstruction scheme. This loss is estimated on the basis of the company's latest financial statements. The following variables are taken into account.

i. Fictitious Assets
ii. Preliminary Expenses
iii. Intangible Assets
iv. Loss on revaluation of assets
v. Arrears of preference dividend

2. **Writing off the loss**

Having estimated the amount of loss, it will be necessary to ascertain the parties who will have to bear this loss. The various parties interested in the company are

i. equity shareholders ii) Preference shareholders iii) Unsecured creditor
iv) Creditors secured by a floating charge v) Creditors secured by fixed charge.

3. **Compensating the parties**

In case only the equity shareholders are required to sacrifice under the reconstruction scheme, there is no need for making any provisions for compensating them since they will automatically be compensated in terms higher income in future when makes higher profit. However if preference shareholder, debenture holders and creditors are required to make sacrifice, some provision must be made for their compensation. This can be done by increasing dividend rate or interest rate.

3. **Arrears of preference dividend**

In such scheme usually arrears of preference are cancelled. While calculating sacrifice made by various parties the cancellation of divided should be considered. This may be paid in terms of deposit certificate of avoid burden of liquid resources of company.

4. **Additional working capital**

Working capital is life blood of the business and therefore, it is necessary that reconstructed company should have adequate working capital. The required fund may provide by existing shareholders and debenture holders. It can also be collected from outsiders but one thing should be take care that is loss of control of existing shareholders.

5. **Funds for fixed Assets**

Sometimes reconstruction of a company may be necessary because the company is not in position to replace or modernise its plant and machinery. In such situation, adequate provision should be made for gap of fund between bank finance available and total fund required for replacement or modernisation. The framing of reconstruction scheme can be well understood with the help of comprehensive illustration given below:

Example: 5 The following is a summary of the balance sheet of a limited company as on 31st Dec. 2012.

Liabilities	**Rs**	**Assets**	**Rs**	**A**	**B**
5000, 6% Commutative pref shares of Rs 10	50,000	Freehold Property	56,550	40,000	50,000
5,000 Equity shares of Rs 10 each	50,000	Plant and Machinery	18,930	10,500	17,500
10% Debentures (Secured on free-hold property)	30,000	Motor vehicles	3,600	3,400	3,600

Bank Overdraft (Unsecured)	9,600	Stock	95,390	75,000	95,390
Trade Creditors	75,240	Trade Debtors	12,430	11,850	12,430
		Cash	460	460	460
		Profit and Loss A/c	27,480		
Total	**2,14,840**	**Total**	**2,14,840**		

Against the balance sheet values of the assets are shown the probable realisation values in the event of a complete liquidation of the company (column A) and the equivalent figures on a 'going concern' basis (Column B). On 31 December 2012, the preference share dividends is three years in arrears and in a liquidation the preference shareholders have a prior claim to these arrears and to repayment of their subscribed capital, but they have no other rights.

You are consulted by A, who holds 2,000 ordinary shares, and who is satisfied that, if the finances of the company can be reorganised , it can be expected to earn profit of not less than Rs 50000 per annum before providing for interest and taxation.

Accepting A's expectation as correct, frame a scheme of reconstruction of the company which should be acceptable to all concerned. Allow for the fact that stock and debtors will continue at their present level, that trade creditors will require to be reduced to Rs 30,000, and that for normal working the company requires cash at bank of at least Rs 12000 instead of an overdraft.

Solution

The preference shareholders of the company are entitled to repayment of capital and arrears of cumulative preference dividend in the event of company's liquidation in priority to the equity shareholders. Thus, in the event of company's liquidation, the loss of capital will have to be mainly borne by the equity shareholders. However, in the present case in the event of company's liquidation, losses will be so heavy that they will not only wipe out completely the equity shares capital but also wipe out a substantial portion of the preference share capital.

However, on a going concern basis, the preference shareholders are fully covered by the available assets. A sum of about Rs 3 per share would be left for equity shareholders after satisfying the claims of the company continues to carry on business.

The scheme of reconstruction may be drafted on the following lines:

i) Loss to be written off on 'going concern basis'

Particulars	Rs
Freehold property	Rs 6,550
Plant and machinery	1,430
Profit and loss A/c	27,480
Add: Estimated reconstruction expenses	2,040
Loss to be written off	37,500

ii) Preference shareholders are requested to cancel the arrears of preference dividend for last three years amounting to Rs 9,000 in all.

iii) The entire loss of Rs 37,500 be written off against the equity share capital. Each equity share may be reduced to Rs. 2.5 per share from Rs 10 each for this purpose.

iv) The authorised share capital of the company be restored to its present figure of Rs 1 lakh.

v) In order to compensate the preference dividend be increased from 6 percent to 8 percent.

vi) The following additional working capital may be raised:

Particulars	**Rs**
Payment of trade creditors	45,240
Repayment of bank overdraft	9,600
Bank Balance (say)	12,660
Additional working capital	**67,500**

The present unissued share capital amounts to Rs 37,500. It would be, therefore, necessary to increase the authorised share capital by another (say) Rs 30,000. In order to avoid a highly geared capital structure, it will be appropriate to raise additional capital by issue of 27,000 equity shares of Rs 2.50 each. These new shares should be offered for subscription at par to both present preference and equity shareholders in the ratio of 1:2.

vii) As a result of the above reconstruction scheme, the company's expected profit of Rs 50,000 would be available for distribution in the following manner:

Particulars	***Rs***
Interest on Debenture	3,000
Provision for taxation (at 50%)	23,500
Dividend on preference @ 8%	4000
Dividend on equity shares of Rs 80,000	12,000
Carry forward	7,500
Company's expected profit	50,000

1.7 Summary

Reconstruction is a process by which affairs of a company are reorganised by revaluation of assets, reassessment of liabilities and writing of losses already suffered by company through reduction of share capital or varying rights of shareholders. Reconstruction account is a new account opened for adjustment loss which is not represented by lost assets. If some balance in reconstruction account remains then it should be transferred to Capital Reserve Account. Schemes of internal reconstruction include reduction of share capital and other liabilities, re-organization or alteration of share capital, variation of shareholders rights, compromise / arrangement and surrender of shares.

1.8 Keywords

Dissenting shareholders: A shareholders who has not assented to the scheme of reconstruction.

External reconstruction: A reconstruction that involves liquidation of a company having bad financial position and formation of new company to purchase its business.

Internal reconstruction: Reorganisation of capital structure of company without liquidation.

1.9 Review Questions

1. Explain various points which kept in while framing a reconstruction scheme.
2. Define the term ‘Capital reduction’ and explain legal process of capital reduction.
3. Define the term 'surrender of shares'. Explain accounting treatment of surrender of shares with suitable example.
4. Explain various journal entries in case of internal reconstruction with hypothetical examples.
5. The balance sheet of ABC Company Ltd. as on 31st March, 2012 was as follows.

BALANCE SHEET OF ABC COMPANY LTD.
as on 31st March, 2012

Liabilities	**Rs**	**Assets**	**Rs.**
10,000 Equity Shares @ 10	1,00,000	Goodwill	10,000
10,000 Preference Shares @ 10	1,00,000	Fixed Assets	90,000
		Stock	30,000
		Debtors	25,000
		P & L A/c	45,000
Total	2,00,000	Total	2,00,000

It was resolved that equity shares of Rs. 10 each be reduced to fully paid shares of Rs. 6 each and 7% preference shares of Rs 10 each be reduced to 7-1/2 % fully paid preference shares of Rs. 7 each. It was further resolved that amount so available be used for writing off the debit balances of profit and loss account, goodwill account, and other fixed assets as much as possible. There were arrears of preference dividend for the last three years but the amount was to be cancelled. Give journal entries and draw the revised balance sheet.

6. The following is the abridged balance sheet of Hind Ltd. as on 31st March 2012.

BALANCE SHEET OF HIND LTD.

as on 31st March 2012

Liabilities	Rs	Assets	Rs.
15,000 Equity Shares @ 10	1,50,000	Goodwill	35,000
10,000 Cumulative Preference Shares @ 10	1,00,000	Net Tangible Assets	1,52,000
		Profit and Loss A/c	63,000
Total	2,50,000	Total	2,50,000

The preference dividend is in arrears for three years. The net tangible assets are estimated to the worth Rs 1, 36,000. On the expectation that the annual profits will be Rs. 15,000 draft a scheme of reconstruction to be submitted to the directors mentioning the important matters which would require consideration and state the effect of such proposal on two classes of shareholders. Redraft the balance sheet.

1.10 Further Readings

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.
2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.
5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

LESSON-2

ACCOUNTING FOR AMALGAMATION OF COMPANIES

2.0 Objectives

After going through this chapter, the student will be able to:

1. understand the concept of merger and amalgamation;
2. describe the accounting treatment of amalgamation and
3. understand the difference between amalgamation and external reconstruction.

2.1 Introduction

Compelled by the present economic scenario and market trends, corporate restructuring in terms of mergers, amalgamations, takeovers and acquisitions, has emerged as the best form of endurance and growth. The opening up of the Indian economy and the Government's decision to disinvest has made corporate restructuring more pertinent today. In the last few years, India has followed the worldwide trends in consolidation amongst companies through mergers and acquisitions. Companies are being taken over, enterprises are being hived off, and joint ventures identical to acquisitions are being made and so on. It may be reasonably stated that the quantum of mergers and acquisitions in the last few years is more than the corresponding quantum in the four and a half decades post independence. Supreme Court of India in the landmark judgement of HLL-TOMCO merger has said that "in this era of hyper competitive capitalism and technological change, industrialists have realised that mergers/acquisitions are perhaps the best way to reach a size comparable to global companies so as to successfully compete with them. The harsh reality of globalisation has dawned that companies which cannot compete globally must sell out as an inevitable alternative".

2.2 Meaning and Definition

Amalgamation is an arrangement where two or more companies consolidate their business to structure a new firm, or become a subsidiary of any one of the company. For practical purposes, the words amalgamation and merger are used interchangeably. However, there is a minor difference. Merger involves the fusion of two or more companies into a single company where the identity of some of the enterprises gets dissolved. On the other hand, amalgamation means dissolving the entities of amalgamating companies and forming a new company having a separate legal entity.

Amalgamation

Amalgamation comes into existence when two or more than two established joint stock companies come together to form a large one. After amalgamation each company loses its separate legal identity. Newly formed company generally take over all the assets and liabilities of old companies. Main purpose of a new company is to expand a business to obtain the benefits of large scale.

Merger

When a joint stock company absorbs one or more than one company is called merger. Each firm which is absorbed loses its existence. It eliminates the competition and obtains the monopoly profit; it reduces the cost and obtains the tax advantages.

According to Section 2(1B) of the Income Tax Act, 1961, “Amalgamation in corporate sector means the unification of one or more companies with another company or the merger of two or more companies to form one company (the company or companies which so merge being referred to as the amalgamating company or companies and the company with which they merge or which is formed as a consequence of the merger, as the amalgamated company) in such a way that

1. All the property of the amalgamating company or companies immediately before the amalgamation becomes the property of the amalgamated company by virtue of amalgamation

2. All the liabilities of the amalgamating company or companies immediately before the amalgamation become the liabilities of the amalgamated company by virtue of amalgamation

3. Shareholders holding not less than 3/4th in value of the shares in amalgamating company or companies (other than shares held therein immediately before the amalgamation or by a nominee for the amalgamated company or its subsidiary) become shareholders of the amalgamated company by virtue of the amalgamation, otherwise than as a outcome of the acquisition of the property of one company by another company pursuant to the purchase of such property by the other company or as a result of distribution of such property to the other company after the winding up of first mentioned company.

2.3 Types of Merger and Acquisition

There are many types of merger and acquisition that redefine the business world with new strategic alliances and improved corporate philosophies. From the business structure point of view, some of the most familiar and significant types of merger and acquisition are listed below:

Horizontal Merger

This kind of merger exists between two companies who compete in the same industry fragment. The two companies bond together their operations and gains potency in terms of improved performance, increased capital, and better profits. This kind of merger substantially reduces the number of competitors in the segment and gives a higher edge over competition.

Vertical Merger

It is a kind of merger in which two or more companies in the same industry but in different fields come together in business. In this form, the companies in merger choose to combine all the operations and productions under one shelter. It is like encircling all the requirements and products of a single industry fragment.

Co-Generic Merger

Co-generic merger is a kind of merger in which two or more companies in association are some way or the other related to the production processes, business market, or basic requisite technologies. It includes the expansion of the product line or acquiring components that are all the way required in day to day operations. This kind of merger offers immense opportunities to businesses as it opens a hue gateway to diversify around a common set of resources and strategic requirements.

Conglomerate Merger

Conglomerate merger is a kind of venture in which two or more companies belonging to different industrial sectors combine their operations. The businesses of merged companies are not related to each other's kind of business and product line rather their operations overlap that of each other. This is just a confederation of businesses from different verticals under one flagship enterprise or firm.

Reverse Merger

A reverse merger refers to an arrangement where private company acquires a public sector company, usually a shell company, in order to obtain the status of a public company. It is also known as a reverse takeover, it is a substitute to the traditional initial public offering (IPO) method of floating a public company. It is an easier approach that allows private companies to change their type while avoiding the complex regulations and formalities related with an IPO. Also, the extent of ownership and control of the private stakeholders increases in the public company. It also leads to combining of resources thereby giving more liquidity to the private company.

Types of Amalgamation

Amalgamation is of two types

a) Amalgamation in the Nature of Merger

b) Amalgamation in the nature of Purchase

a) Amalgamation in the Nature of Merger

There are some conditions (basically 5) that must be fulfilled for amalgamation in the nature of merger:

1. The transferor company must take over all the assets and all the liabilities of the transferor company.

2. Assets and liabilities of the transferor company will be taken over by the transferee company at their book value.

3. The transferee company must carry on the same nature of business as that of the transferor company.

4. At least 90% of the equity shareholders of the transferor company must agree to become the shareholders of the transferee company.

5. The transferee company must discharge the amount of purchase consideration by issuing its equity shares to the equity shareholders of the transferor company and if there is any fraction it would be paid in cash.

b) Amalgamation in the Nature of Purchase

If any one or more of the above mentioned condition is/are not fulfilled, the situation is called 'Amalgamation in the Nature of Purchase'.

2.4 Purchase Consideration

Purchase consideration is the amount which is paid by the transferee company for the purchase of the business of the transferor company. In simple words, consideration for amalgamation means the aggregate of the shares and other securities issued and payment in cash or other assets by the transferee company to the shareholders of the transferor company. It should not include the amount of obligations taken over by the transferee company, for which payment will be made directly by this company. Payments made to debenture-holders should not be considered as part of purchase consideration. While calculating the amount of purchase consideration, special care should be given to the valuation of assets and liabilities of the transferor company. The working out of purchase consideration is very important and may be calculated in the following ways:

2.4.1 Methods of Calculation of Purchase Consideration: Following are the methods of calculation of purchase consideration:

(i) **Lump Sum Method**: When the transferee company agrees to pay a fixed sum to the transferor company, this method shall be called a lump sum payment of purchase consideration. For example, if A Ltd. purchases the business of B Ltd. and agrees to pay Rs. 35, 00,000 in all, it is an example of lump sum payment.

(ii) **Net Worth (or Net Assets) Method**: According to this technique, the purchase consideration is calculated by calculating the net worth of the assets taken over by the transferee company. The net worth is calculated by adding up the agreed value of assets taken over by the transferee company minus agreed value of liabilities to be assumed by the transferee company.

Example: 1 A Ltd takes over the business of B Ltd at the following values:

Fixed Assets	Rs. 3, 00,000
Current assets	Rs. 1, 00,000
Debentures	Rs. 50,000
Current Liabilities	Rs. 1, 00,000

Calculate the amount of Purchase Consideration:

Solution

Calculation of Purchase consideration has been calculated as follows:

Assets taken over	Rs	Rs
Fixed assets	3, 00,000	
Current assets	1, 00,000	400,000
Less Liabilities taken over		
Debenture	50,000	
Current Liabilities	1,00,000	1,50,000
Purchase Consideration		**2,50,000**

2.4.2 Methods of Accounting

1. The Pooling of Interests Method

Under the pooling of interest method, the liabilities, assets 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 transferee and the transferor companies have contradictory accounting policies, a standardized set of accounting policies is adopted following the amalgamation. The special effects on the financial statements of any changes in accounting policies are reported in accordance with Accounting Standard (AS) 5, Net Profit or Loss for the Period, Past Period Items and Changes in Accounting Policies.

2. 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 liabilities and assets of the transferor company on the basis of their fair values at the date of amalgamation. The identifiable liabilities and assets may include assets and liabilities not recorded in the financial statements of the transferor company. Where assets and liabilities are re-stated on the basis of their fair values, the computation of fair values may be influenced by the intentions of the transferee company. For example, a transferee company may have a specialised use of an asset, which is not available to other prospective buyers. The transferee company may propose to effect changes in the activities of the transferor company which necessitate the creation of specific provisions for the expected costs, e.g. deliberate employee termination and plant relocation costs.

Example: **2** The following are the balance sheet of P Ltd and S Ltd as on 31st March 2012.

Liabilities	**P Ltd. (000)**	**S Ltd (000)**
Equity Share @ 10	72,000	30,000
11 % Preference Share capital @ 100 each		17,000
General Reserve	8,000	4,500
Export Profit Reserve		2,000

Profit and Loss Account	7,500	4,000
9 % Debenture @ Rs 100		5,000
Creditors	11,500	3,500
Total	**99,000**	**66,000**
Assets		
Land and Building	25,000	
Plant and Machinery	32,500	29,000
Furniture and Fittings	5,750	9,410
Stock	21,500	17,390
Debtors	7,250	5,200
Cash at Bank	7,000	5,000
Total	**99,000**	**66,000**

P Ltd takes over S Ltd 1st April, 2012 and discharges consideration for the business as follows:

i) Issued 35 lakh fully paid equity shares of Rs 10 each at par to the equity shareholders of S Ltd.

ii) Issued fully paid 12% preference share of Rs. 100 each to discharge the preference shareholders of S Ltd at a premium of 10%.

iii) It is agreed that the debentures of S Ltd will be converted into equal number and amount of 10% debentures of P Ltd. The statutory reserve of S Ltd is to be maintained for two more years.

You are required to show the balance sheet of P Ltd using:

a) Pooling of interest method

b) Purchase method

Solution

a) Pooling of Interest Method

Balance Sheet of P Ltd as on 31st March 2012

Liabilities	*Amt(000)*	***Assets***	*Amt (000)*

Equity shares @ 10	1,07,000	Land and Buildings	25,000
12% Preference shares@ 100	18,700	Plant and Machinery	61,500
General Reserve	9,800	Furniture and Fittings	15,160
Export Profit Reserve	2,000	Stock	38,890
Profit and Loss Account	7,500	Debtors	12,450
10% Debenture of Rs 100	5,000	Cash at Bank	12,000
Creditors	15,000		
Total	**1,65,000**	**Total**	**1,65,000**

Working note

P Ltd General Reserve

P Ltd General reserve	8,000		
Add: S Ltd's general reserve	4,500		
S Ltd's profit and loss A/c	4,000		**16,500**
Less: Consideration for equity shares	35,000		
Consideration for preference shares	18,700	53,700	
Less: S Ltd's share capital		(47,000)	**(6,700)**
Reserve Appearing in Bal. sheet			**9,800**

(b)Purchase Method

Balance Sheet of P Ltd as on 31st March 2012

Liabilities	*Amt(000)*	***Assets***	*Amt (000)*
Equity shares @ 10	1,07,000	Land and Buildings	25,000
12% Preference shares@ 100	18,700	Plant and Machinery	61,500
General Reserve	8,000	Furniture and Fittings	15,160
Capital Reserve	3,800	Stock	38,890
Export Profit Reserve	2,000	Debtors	12,450
Profit and Loss Account	7,500	Cash at Bank	12,000
10% Debenture of Rs 100	5,000	Amalgamation Adj A/c	2000
Creditors	15,000		

Total	**1,67,000**	**Total**	**1,67,000**

Working Note: Calculation of capital reserve arising on amalgamation

Total assets taken over		**66,000**
Less: 10 % Debenture	5,000	
Creditors	3,500	8,500
Net Asset taken over		**57,500**
Less: Consideration to equity shareholders	35,000	
Consideration to preference share holders	18,700	53,700
Capital on amalgamation		**3,800**

2.4.3 Difference between Pooling of Interest and Purchase Method

The table given below illustrates some differences between the consolidated financial statement of the pooling of interest method and purchase method.

Basis	Pooling of Interest Method	Purchase Method
Book Value	Typically lower than purchase method, as in this method, goodwill asset is not created.	Typically higher than pooling method.
Trend in Earnings	Higher than purchase method because income statements are combined retroactively.	Lower than the pooling method because pre-acquisition income statements are not combined.
Trend in Sales	More accurate than the purchase method, as income statements are pooled retroactively.	Distorts growth perception of the acquiring company, as much of its sales growth can be credited to the acquisition.
EPS	Higher than the purchase method, as the income statement is pooled for the entire reporting period, rather than only for the acquisition date.	Lower than the pooling method.
ROA & ROE	Higher	Lower

Example: 3 Consider the Balance sheet of Rama Ltd. and Shyama Ltd. 31st March 2013

Balance Sheet as on 31st March 2013

Liabilities	**Rama** *Amt(000)*	**Shyama** *Amt(000)*	***Assets***	**Rama** *Amt(000)*	**Shyama** *Amt(000)*
Equity Share	50,00	30,00	Land	25,00	15,50
Preference Shares	22,00	17,00	Plant	32,50	17,00
Gen Reserve	5,00	2,50	Furniture	5,75	3,50
Export Res.	3,00	2,00	Investment	7,00	5,00
Investment All Res.		1,00	Stock	12,50	9,50
Profit and Loss A/c	7,50	5,00	Debtor	9,00	10,30
Debentures	5,00	3,50	Cash	7,25	5,20
Creditors	4,50	3,50			
Others Current Liabilities	2,00	1,50			
Total	99,00	66,00	Total	99,00	66,00

Other information: Rama Ltd takeover Shyama Ltd on 1st April 2013 and discharges the purchase consideration as follows:

1. Issued 350,000 equity shares of Rs 10 each at par to the equity shareholders of Shyama Ltd.
2. Issued 15% preference shares of Rs 100 each to discharge preference shareholders of Shyama Ltd at 10% premium.
3. The debentures of Shyama Ltd have been converted into equal number of debentures of Rama Ltd.
4. The statutory Reserve of Shyama Ltd is to be maintained for two more years.

Show the balance sheet of Rama Ltd after amalgamation in case

1. Amalgamation in nature of merger
2. Amalgamation in nature of Purchase

Solution:

Amalgamation in Nature of Merger

Balance Sheet of Rama Ltd

Liabilities	Amount (000)	Assets	Amount (000)
Share capital	12,570	Fixed Assets(tangible)	9,925
Res & Surplus	1,930	Non Current Investment	1200
Long term Borrowing	850	Inventories	2200
Trade payable	800	Bill Receivable	1930
Others CL	350	Cash	1245
Total	16,500	Total	16,500

Notes of Computation

Share capital	*Amount(000)*	*Total(000)*
Equity, 85000 @100	8500	
Preference shares		
18700, 15% pref. Share @100	1870	
22000, 14% pref. Share @100	2200	
Total		**12,570**
Reserve& Surplus		
GR of Rama Ltd	500	
Add. GR of Shyama	250	
Less: Adj for amalgamation	(670)	80
Export Profit Res of Rama Ltd	300	
Add: Export of Shyama	200	500
Investment Allow. Res		100
P& L of Rama	750	
Add: P& L of Shyama	500	1250
Total		**1,930**
Long term Borrowings		
Secured		
8500, 35% Debentures @ 100		850
Total		**850**
Tangible Assets		

Land	4050
Plant	4950
Furniture	925
Total	**9925**

2. Amalgamation in Nature of Purchase

Balance Sheet of Rama Ltd

Liabilities	*Amt (000)*	***Assets***	*Amt (000)*
Share capital	12,570	Fixed Assets(tangible)	9,925
Res & Surplus	2230	Non Current Investment	1200
		Other Non -current assets	300
Long term Borrowing	850	Inventories	2200
Trade payable	800	Bill Receivable	1930
Others CL	350	Cash	1245
Total	16,800	Total	16,800

Notes of Computation

Share capital	Amount(000)	Total(000)
Equity, 85000 @100	8500	
Preference shares		
18700, 15% pref. Share @100	1870	
22000, 14% pref. Share @100	2200	
Total		**12,570**

Reserve& Surplus

Capital Reserve	380
Gen Res	500
Export Profit	500
Investment All	100
Surplus	750

	Total		**2,230**
Long term Borrowings			
	Secured 8500, 35% Debentures @ 100		850
	Total		**850**
	Tangible Assets		
	Land	4050	
	Plant	4950	
	Furniture	925	
	Total		**9925**

Working note: Capital reserve arising on Amalgamation

A. Net Assets takeover

Sundry Assets		66, 00
Less: 13% Debenture	3, 50	
Trade creditor	3, 50	
Other current liab	*150*	*(8, 50)*
	=====	--------
		5750
		======

B. Purchase Consideration

To Equity Shareholders of Shyama Ltd	35 00
To Preference Shares of Shyama Ltd	18 70

	5370
	=====
Capital Reserve (A-B)	380

2.4.4 Journal Entries in case of Merger and Amalgamation: Following are the journal entries in case of merger:

(a) Journal Entries in the Books of Transferor Company: Following are the journal entries in the books of Transferor Company:

Sr. No	***Particular***	***Dr.***	***Cr.***
1.	When Assets are transferred to Realisation A/c Realisation Dr To Sundry Assets A/c (Write Individually at Book Value)		
2.	When Liabilities are transferred to Realisation A/c Sundry Liabilities A/c (Write Individually)Dr To Realisation A/c(Book Value)		
3.	When Purchase consideration becomes Due Transferee Co. A/c Dr To Realisation A/c (with amount of Purchase consideration)		
4.	When any asset sold in the market by Transferor Company Bank A/c Dr To Realisation A/c (only if Amalgamation is in nature of Purchase)		
5.	When any liability is paid off by transferor company itself Realisation A/c Dr To Bank A/c only if Amalgamation is in nature of Purchase		
6.	When preference share holders are discharged at premium or Discount **At Premium** Realisation A/C Dr To Preference Share Holders A/c **At Discount** Preference Share Holders A/c Dr To Realisation A/c		

7. For recording of Dissolution/Realisation Expenses

a). When realisation Expenses are paid by the transferor company itself.

Realisation A/c Dr

To Bank A/c

b). When realisation Expenses are paid by the transferee Company.

No Entry will be passed

c).When realisation expenses are paid by transferor company and they are reimbursed by the transferee company.

i). Transferee Company A/c Dr

To Bank A/c

ii) Bank A/c Dr

To Transferee Company A/c

8. For recording of Profit/Loss on Realisation

a). In Case of Profit

Realisation A/c Dr

To Equity Share Holders A/c

b). In Case of Loss

Equity Share Holders A/c Dr

To Realisation A/c

9. When Purchase Consideration is received

Equity Share in Transferee Company A/c Dr

Preference Share in Transferee Company A/c Dr

Debenture in Transferee Company A/c Dr

Other Securities in Transferee Company A/c Dr

Cash A/c Dr

To Transferee Company A/c

Note: Purchase consideration can be discharged by any one or more than one or by all which are mentioned above

10. When preference share capital being transferred to Preference share holders account

Preference Share Capital A/c Dr

To Preference share holders A/c

11. When purchase consideration is discharged to preference share holder

Preference Share holders A/c Dr

To Equity Share in Transferee Co. A/c

To Preference Share In Transferee Co. A/c

To Debentures in Transferee Company A/c

To Other Securities in Transferee Co. A/c

To Cash A/c

12 When Equity Share Capital and Reserve and Surplus are Transferred to Equity Share holders A/c

Equity Share Capital A/c Dr

Reserve & Surplus A/c Dr

To Equity Share Holders A/c

13. When Miscellaneous Expenditure and Profit & Loss A/c (Dr.) Balance is adjusted in Equity Share Holders A/c

Equity Share Holders A/c Dr

To Miscellaneous Expenditure A/c

To Profit & Loss A/c

14. When the Amount of Purchase Consideration is discharged to Equity Share Holders A/c

Equity Share Holders A/c Dr

To Equity Share in Transferee Company A/c

To Preference Share In Transferee Co. A/c

To Debentures in Transferee Co. A/c

To Other Securities in Transferee Co. A/c

To Cash A/c

(a) Journal Entries in the Books of Transferee Company: Following are journal entries in the book of transferee company:

Sr. No.	*Particulars*	Dr.	Cr.
A	**In The Nature of Merger Pooling of Interest Method:** Following are the journal entries in pooling of interest method		
1.	When Business of transferor co. is taken over Business Purchase A/c Dr To Liquidator of Transferor Co.		
2.	When Assets and Liabilities taken over are recorded Sundry Assets A/c (Individually)Dr Reserve & Surplus A/c (Bal. Fig.) Dr To Sundry Liabilities (Individually) To Business Purchase To Reserve & Surplus (Bal. Fig.) Note: Any one Bal. Fig. will become either in Dr. or Cr.		
3.	When Purchase consideration is discharged Liquidator of Transferor Co. A/c Dr To Equity Share Capital A/c To Securities Premium A/c To Preference Share Capital A/c To Cash A/c		
4.	When Realisation/Dissolution expenses of transferor Co. paid by transferee Co. General Res. A/c/ Profit and Loss A/c Dr To Bank A\c		
5.	When Shares are issued to General Public Bank A/c Dr To Share Appl. & Allotment A/c		
6.	When Application and Allotment Money is transferred to Share Capital A/c **At Par.** Share Appl. & Allotment A/c Dr To Share Capital A/c **At Pre.** Share Appl. & Allotment A/c Dr To Share Capital A/c To Securities Premium		

At Dis.

Share Appl. & Allotment A/c Dr
Discount of Issue of Shares Dr
To Share Capital A/c

7. When formation expenses of transferee co. are recorded.

Formation Exp. /Preliminary Exp. A/c Dr

To Bank A/c

8. When Inter Co. transaction are recorded

Sundry Creditors A/c Dr

To Sundry Debtors A/c or Bills Payable A/c

To Bills Receivable A/c or Loan Taken A/c

To Loan Given A/c

9. When unrealized profit is recorded

Reserve & Surplus/ P&L A/c Dr

To Stock A/c/Current Assets A/c

Note: When there is no profit in Balance sheet then Debit the Goodwill

10. When Statutory Reserve of transferor Co. are transferred to transferee Co.

Amalgamation Adjustment A/c Dr

To Statutory Reserve A/c

Note: At the time of Merge Balance Sheet, Amalgamation Adjustment A/c will be shown in Miscellaneous Expenditure A/c

B **In The Nature of Purchase:** Following are the journal entries in case of nature of purchase

1. When Business of Transferor Co. is Taken Over
Business Purchase A/c Dr

To Liquidator of Transferor Co. A/c

2. When Assets and Liabilities taken over are recorded
Sundry Assets A/c (Individually)Dr
Reserve & Surplus A/c (Bal. Fig.) Dr

To Sundry Liabilities A/c (Individually)
To Business Purchase A/c
To Capital Reserve A/c (Bal. Fig.)

Note: 1. Any one Bal. Fig. will become either in Dr. or Cr. 2. If Purchase consideration is calculated by Net Assets Method there will no difference but if calculated by Net Payment Method difference will become either in Dr. or Cr.

3. When Purchase consideration is discharged
   Liquidator of Transferor Co. A/c Dr
   To Equity Share Capital A/c
   To Securities Premium A/c
   To Preference Share Capital A/c
   To Debentures To Other Securities A/c
   To Cash A/c
4. When Realisation/Dissolution expenses of Transferor Co. paid by Transferee Co.
   Realisation A/c Dr
   To Bank A/c
5. When Shares are issued to General Public
   Bank A/c Dr
   To Share Appl. & Allotment A/c
6. When Application and Allotment money is transferred to Share Capital A/c

   At Par.

   Share Appl. & Allotment A/c Dr
   To Share Capital A/c

   At Pre.

   Share Appl. & Allotment A/c Dr
   To Share Capital A/c
   To Securities Premium A/c

   At Dis.

   Share Appl. & Allotment A/c Dr
   Discount of Issue of Shares A/c Dr
   To Share Capital A/c
7. When formation Expenses of Transferee company are recorded.

Formation Exp./Preliminary Exp. A/c Dr

To Bank A/c

8. When formation Expenses of Transferee company are recorded.

Formation Exp.\Preliminary Exp. A/c Dr

To Bank A/c

9. When Inter Company Transaction are Recorded

Sundry Creditors A/c Dr

To Sundry Debtors A/c or Bills Payable A/c

To Bills Receivable A/c or Loan Taken A/c

To Loan Given A/c

10. When unrealized profit is recorded

Reserve & Surplus/P&L A/c Dr

To Stock A/c/Current Assets A/c

Note: When there is no profit in Balance sheet then Debit the Goodwill

Example: 4 A Ltd acquires B Ltd. for a consideration of Rs. 38, 00,000 to be satisfied in the form of fully paid equity shares of Rs. 10 each. The balance sheets of the two companies on 31st Dec 2012, the date of acquisition, were as follows:

BALANCE SHEET
as on 31st Dec., 2012

Liabilities	**A Ltd.**	**B Ltd.**	**Assets**	**A Ltd.**	**B Ltd.**
Equity shares	40,00,000	25,00,000	Sundry Assets	96,00,000	58,00,000
Gen. Res.	15,00,000	30,000			
Development Rebate Res.	3,00,000	1,00,000			
Export Profit Res.	6,00,000	4,00,000			
Profit & Loss A/c	12,00,000	9,00,000			

Sundry Liabilities	20,00,000	16,00,000			
Total	**96,00,000**	**58,00,000**	**Total**	**96,00,000**	**58,00,000**

You are required to pass the necessary journal entries in the books of A Ltd. (transferee company) when amalgamation is nature of (i) merger and (ii) by way of purchase.

Solution

When amalgamation by way of merger

In such case accounting entries are passed according to "pooling of interest" method. The following entries will be in the books of A Ltd.

Journal Entries

Date	***Particulars***	***Dr. Rs.***	***Cr. Rs.***
	Business Purchase A/c Dr	38,00,000	
	To Liquidator of B Ltd.		38,00,000
	(Being purchase consideration due)		
	Sundry Debtors A/c Dr	58,00,000	
	General Reserve A/c(bal. figure)	13,00,000	
	To Sundry Liabilities A/c		16,00,000
	To Profit & Loss A/c		9,00,000
	To Export Profit Res. A/c		4,00,000
	To General Res. A/c		3,00,000
	To Development Rebate Res A/c		1,00,000
	To Business Purchase A/c		38,00,000
	(Being merger of assets and liabilities)		
	Liquidator of B Ltd. A/c Dr	38,00,000	
	To Equity Share Capital A/c		38,00,000
	(Being settlement of Purchase consideration)		

When amalgamation is by way purchase

In such a case the following entries are passed as per purchase method.

Journal Entries

Date	***Particulars***	***Dr. (Rs.)***	***Cr. (Rs.)***
	Business Purchase A/c Dr	38,00,000	
	To Liquidator of B Ltd.		38,00,000
	(Being purchase consideration due)		
	Sundry Debtors A/c Dr	58,00,000	
	To Sundry Liabilities A/c		16,00,000
	To Business Purchase A/c		38,00,000
	To Capital Reserve		4,00,000
	(Being merger of assets and liabilities)		
	Liquidator of B Ltd. A/c Dr	38,00,000	
	To Equity Share Capital A/c		38,00,000
	(Being settlement of Purchase consideration)		
	Amalgamation Adjustment A/c Dr	5,00,000	
	To Development Rebate Res. A/c		1,00,000
	To Export Profit Reserve A/c		4,00,000
	(Being carrying forward of statutory reserve)		

2.5 Amalgamation and External Reconstruction

Meaning of External Reconstruction: Reconstruction refers to certain arrangements made by financially unstable companies. The reconstruction planning made by a company, to face its financial difficulties, may be internal or external. Outside reconstruction refers to closing/liquidating the company and starting again a new or a fresh. That is technically, a fresh company will be floated or formed to take over the existing company. In-house reconstruction refers to making internal adjustments for overcoming financial difficulties. **Difference between Amalgamation and External Reconstruction**

The major differences between amalgamation and external reconstruction are as follows:

1. External reconstruction involves liquidation of only one company, while amalgamation of companies involves liquidation of two or more companies.

2. But External reconstruction does not result in any combination but amalgamation of companies results in combination of companies.

Difference between External Reconstruction and Absorption

The major differences between external reconstruction and absorption are as follows:

1. External reconstruction involves formation of a new company; however absorption of companies does not involve formation of a new company.

2. Absorption of companies results in liquidation of one or more companies while external reconstruction results in liquidation of only one company.

3. External reconstruction does not involve any combination, whereas absorption of companies involves combination of companies.

2.5.1 Accounting for External Reconstruction

The accounting procedure in case of external reconstruction is the same as in case of amalgamation or absorption in the nature of purchase. However, there are no different methods in this case, as in case of amalgamation or absorption, where there are of two methods viz, in nature of merger and in the nature of purchase.

Steps in Accounting for External Reconstruction are outlined below:

Calculation of purchase consideration:

I. Ascertainment of discharge of purchase consideration

II. Closing the books of vendor company (Vendor company is the company which is being liquidated and taken over) or transferor company

III. Passing opening entries in the books of purchasing company (i.e., Transferee Company or the new company floated.

Example: 5 The balance sheet of H Ltd as on 31st March, 2012 was as follows:

Liabilities	***Rs***	***Assets***	***Rs***
50000, 12% Cumulative Preference Shares of Rs 10 each, fully paid	5,00,000	Goodwill	4,00,000
1,50,000 Equity Shares of Rs 10 each fully paid	15,00,000	Plant and Machinery	7,00,000
10% Debentures	3,00,000	Furniture and Future	2,00,000
Creditors	2,00,000	Patents	1,50,000
		Stock	4,90,000
		Debtors	2,55,000
		Bank	5,000
		Preliminary Expenses	8,000
		Discount on issue of Debentures	12,000
		Profit and Loss Account	2,80,000
	25,00,000		**25,00,000**

The following scheme of external reconstruction was agreed upon:

(i) A new company to be formed called J Ltd with an authorised capital of Rs. 32, 50,000 in equity shares of Rs. 10 each.

(ii) One equity shares, Rs 5 paid up, in the new company to be allotted for each equity shares in the old company.

(iii) Two equity shares, Rs 5 paid-up, in the new company to be allotted for each preference shares in the old company.

(iv) Arrears of preference dividends to be cancelled.

(v) Debenture holders to receive 30,000 equity shares in the new company credited as fully paid.
(vi) Creditors to be taken over by the new company.
(vii) The remaining unissued shares to be taken up and paid for in full by the directors.
(viii) The new company to take over the old company's assets except patents, subject to writing down plant and machinery by Rs. 2, 90,000 and stock by Rs 60,000.
(ix) Patents were realised by H Ltd for Rs. 10,000.

Show important ledger accounts in the books of H Ltd and open the books of J Ltd. by means of journal entries and give the initial balance sheet of J Ltd. Expenses of H Ltd came of Rs. 10000.

Solution:

Calculation of the consideration

Particulars	*Number of shares allotted*	*Amt Credited as paid*	*Total Amt*
12 % cumulative Preference Shareholders (50,000 X 2)	1,00,000	5	5,00,000
Equity shareholders	1,50,000	5	7,50,000
Total	**2,50,000**		**12,50,000**

Books of H Ltd

Realisation Account

Particulars (Dr)	*Rs*	*Particulars (Cr)*	*Rs*
To Goodwill	4,00,000	By 10 % Debentures	3,00,000
To Plant and Machinery	7,00,000	By Creditors	2,00,000
To Furniture and Fixtures	2,00,000	By J Ltd (consideration)	12,50,000
To Patents	1,50,000	By Bank (sale of Patents)	10,000
To Stock	4,90,000	By Equity shareholders A/c (loss)	4,50,000
To Debtors	2,55,000		
To Bank	5,000		
To Bank (Realisation expenses)	10,000		
Total	**22,10,000**		**22,10,000**

J Ltd Account

Particulars (Dr)	*Rs*	*Particulars (Cr)*	*Rs*
To Realisation Account	12,50,000	By Equity Shares in J Ltd (Rs 5 paid up)	12,50,000

Equity Shares in J Ltd (Rs 5 Paid up)

Particulars (Dr)	*Rs*	*Particulars (Cr)*	*Rs*
To J Ltd	12,50,000	By 12% Cumulative Preference Shareholders Account	5,00,000
		By Equity Shareholders Account	7,50,000

	12,50,000		**12,50,000**

12% Preference Shareholders Account

Particulars (Dr)	***Rs***	***Particulars (Cr)***	***Rs***
To Equity Shares in J Ltd	5,00,000	By 12% Cumulative Preference Share capital Account	5,00,000
	5,00,000		**5,00,000**

Cash Book (Bank Columns)

Particulars (Dr)	***Rs***	***Particulars (Cr)***	***Rs***
To Balance b/f	5000	By Realisation A/c (transfer)	5000
To Realisation Account (Patents)	10,000	By Realisation A/c (exp)	10,000
	15000		**15000**

Equity Shareholders Account

Particulars (Dr)	***Rs***	***Particulars (Cr)***	***Rs***
To Preliminary Expenses A/c	8,000	By Equity Share Capital A/c	15,00,000
To Discount on Issue of Shares A/c	12,000		
To Profit and Loss A/c	2,80,000		
To Realisation A/c (loss)	4,50,000		
To Equity Shares in J Ltd (Rs. 5 Paid up)	7,50,000		
	15,00,000		**15,00,000**

Books of J Ltd

Journal

Date	***Particular***	***Dr (Rs)***	***Cr (Rs)***
31 March 2012	Business Purchase A/c Dr	12,50,000	
	To Liquidator of H Ltd		12,50,000
	(Amount payable to liquidator of H Ltd)		
	Plant and Machinery A/c Dr	4,10,000	
	Furniture and Fixture A/c Dr	2,00,000	
	Stock Dr	4,30,000	
	Debtors Dr	2,55,000	
	Bank Dr	5,000	
	Goodwill A/c Dr	4,50,000	
	To 10% Debenture (H Ltd) Account		3,00,000
	To Sundry Creditors		2,00,000
	To Business Purchase Account		12,50,000

	(Incorporation of assets and liabilities taken over)		
31 March 2012	Liquidator of H Ltd Dr	3,00,000	
	To Equity Share Capital Account		3,00,000
	(Allotment of 2,50,000 equity shares of Rs 10 each, Rs 5 paid up for consideration)		
	10% Debenture (H Ltd) Account Dr	3,00,000	
	To Equity Share Capital (fully paid) Account		3,00,000
	Bank Dr	4,50,000	
	To Equity Share Capital Account		4,50,000

Balance Sheet of J Ltd as on 31st March 2012

Liabilities	***Rs***	***Assets***	***Rs***
2,50,000 Equity shares @10, Rs 5 paid up	12,50,000	Goodwill	4,50,000
75,000 equity shares of Rs 10	7,50,000	Plant and Machinery	4,10,000
Creditors	2,00,000	Furniture and fixture	2,00,000
		Stock	4,30,000
		Debtors	2,55,000
		Cash at Bank	4,55,000
	22,00,000		**22,00,000**

1.6

Summary

Amalgamation is an arrangement where two or more companies consolidate their business to structure a new firm, or become a subsidiary of any one of the company. For practical purposes, the words amalgamation and merger are used interchangeably. However, there is a minor difference. Merger involves the fusion of two or more companies into a single company where the identity of some of the enterprises gets dissolved. On the other hand, amalgamation means dissolving the entities of amalgamating companies and forming a new company having a separate legal entity. There are two types of amalgamation i.e. amalgamation nature of merger and amalgamation nature of purchase. There are two type of accounting method i.e. pooling of interest method and purchase method. The accounting procedure in case of external reconstruction is the same as in case of amalgamation or absorption in the nature of purchase. However, there are no different methods in this case, as in case of amalgamation or absorption, where are of two methods viz, in nature of merger and in the nature of purchase

2.7 Keywords

- **Amalgamation:** Taking over of the business of two or more companies by a newly formed company for this purpose.
- **Absorption:** Taking over of the business of one or more companies by an existing company.
- **Liabilities:** Claims of outsiders against company.
- **Purchase Consideration**: The amount paid by purchasing company to the vendor for acquiring its business.
- **Trade liabilities**: Liabilities incurred on account of purchase of goods.

2.8 Review Questions

1. Differentiate between the terms 'amalgamation by way of merger' and 'amalgamation by way of purchase' with suitable examples.

2. State the various accounting entries to be passed in the books of vendor company in case of amalgamation.

3. Explain Pooling of Interest method with suitable example.

4. Define the term 'external reconstruction' and differentiate between amalgamation and external reconstruction**.**

5. The Following is the balance sheet of XYZ Co. Ltd. on 31st December, 2012:

BALANCE SHEET
XYZ Co. Ltd.
as on 31st December, 2012

Liabilities	***Rs***	***Assets***	***Rs.***
20,000 Shares@10	2,00,000	Land & building	1,20,000
Debentures	1,00,000	Plant & Machinery	1,50,000
Sundry Creditors	30,000	Work in progress	30,000
Reserve Fund	25,000	Stock	60,000

Dividend Equalization Fund	20,000	Furniture	2,500
Profit and Loss Appropriation A/c	5,100	Sundry Debtors	5,000
		Cash at Bank	12,500
		Cash in Hand	100
Total	**3,80,100**	**Total**	**3,80,100**

The Company is absorbed by ABC Ltd. on the above date. The consideration for absorption is the discharge of debentures at a premium of 5 per cent, taking over the liability in respect of the sundry creditors, and payment of Rs. 7 in cash and one share of Rs. 5 in ABC Co Ltd. at the market value of Rs.8 per share in exchange for one share in XYZ Co. Ltd. The cost of liquidation of Rs. 5000 is to be met by purchasing company. Pass journal entries in the books of both companies and also prepare final accounts.

6. The Balance sheet of X Ltd. and Y Ltd. as at 31st Dec, 2012, are given below:

BALANCE SHEET OF X LTD. & Y LTD.

as at 31st Dec, 2012

Liabilities	**X Ltd.**	**Y Ltd.**	***Assets***	**X Ltd.**	**Y Ltd.**
Equity Shares @100	4,00,000	3,60,000	Premises	1,20,000	------
General Res.	75,000	------	Goodwill	-------	1,20,000
Profit & Loss A/c	38,000	---------	Sundry Debtors	80,000	1,60,000
Sundry creditors	72,000	1,20,000	Stock in trade	3,00,000	90,000
			Bank	85,000	75,000
			P & L A/c	-----	35,000
Total	**5,85,000**	**4,80,000**	**Total**	**5,85,000**	**4,80,000**

A new company XY Ltd. was formed to take over the two businesses entirely on the following understandings:

(a) X Ltd 's Premises to be revalued at Rs 1,50,000, sundry debtors taken over at 90 percent and stock at Rs. 3,15,000.
(b) Y Ltd's Goodwill to be taken over at Rs. 1,60,000, debtors to be taken at Rs. 1,50,000 and stock at Rs. 75,000.

It was decided that the capital of XY Ltd. would consist of both preference and equity and equity share of the face value of Rs. 10 each. Preference shares would be of the order of Rs. 4, 00,000 and the balance would be in equity shares. Both companies would be issued shares of both the types in equal number, except that the surplus capital of X Ltd. would be discharged fully in preference shares. Indicate the number of shares to be issued to each of the absorbed companies and also prepare balance sheet of XY Ltd.

2.9 Further Reading

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.
2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
4. Paul S.K.R,. **Advanced Accountancy**, New Central Book Agency, Calcutta.
5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

LESSON-3

LIQUIDATION OF COMPANIES

3.0 Objectives

After going through this chapter, the student will be able to:

1. understand the concept of liquidation;
2. understand accounting treatment of liquidation;

3.1 Introduction

A company is an artificial person created by law, and therefore, the law alone can dissolve it. On dissolution, the company's name shall be struck off by the Registrar from the Register of Companies and he shall also get the fact published in the Official Gazette.

3.2 Meaning of Liquidation

Liquidation or the winding up of a company means the termination of the legal existence of a company. Under such circumstances, the assets of the company are disposed off and the debts are paid, out of the amount realized from assets or from the contributions made by the members and the surplus if any is distributed among members in proportion to their holding.

3.3 Modes of Winding Up

There are three models of liquidation of a company:

A. Winding up National Company law Tribunal.

B. Voluntary winding up:

(i) Member's voluntary winding up.

(ii) Creditor's voluntary winding up.

3.3.1 Winding up by National Company law Tribunal: A winding up by National Company Law Tribunal, as it is often called, is initiated by an application by way of petition presented to the Tribunal for a winding up order.

It can take place when the company is directed to be wound-up by an order of National Company Law Tribunal. The Tribunal may direct for winding up of a company on the following grounds (Sec 33A):

1. If by a special resolution, company has, resolved that the company be wound up by the order of court.

2. If a default is made in delivering the Statutory Report of the Registrar of Companies or in holding the statutory meeting of the company.

3. If the company does not commence its business within a year from its incorporation or suspends its business for a whole year.

4. If the number of members falls below seven in case of a public company or below two in case of a private company.

5. If the company is unable to pay its debts.

6. If the court is of the opinion that it is just and equitable that the company should be wound up.

3.3.2. Voluntary Winding Up

A company go for voluntarily wound up under the following circumstances:

1. By an ordinary Resolution

(a) Where the time period of the company was fixed by the articles and the period has expired; and

(b) Where the articles provided for winding up on the occurrence of any event and the specified event has occurred.

2. By a Special Resolution: When a resolution has been passed by the members in all other cases for voluntary winding up, it must be notified to the public by an advertisement in the Official Gazette and in newspapers.

3.3.2.1 Types of Voluntary Winding up

The following are the types of winding up of a company:

1. Member's Voluntary Winding Up

At the time of winding up if the company is a solvent company i.e., able to pay its debts and directors, make a declaration to that effect. It will be called a Member's Voluntary Winding up.

2. Creditor's Voluntary Winding Up

When the declaration of solvency is not made and filed with the Registrar, it may be presumed that the company is insolvent. In such case, the company should call a meeting of its creditors for passing the resolution for winding up.

3.4 Contributory

According to Section 428 of the Companies Act, a contributory is "every person liable to contribute to the assets of a company in the process of winding up, and include the any shareholders who are fully paid up and also any person alleged to be a contributory"

In the event of a company being wound up all present and past members (called contributories) are liable to jointly contribute to the assets of the company an amount sufficient for payment of its debts and liabilities, to meet up the cost of liquidation and adjust the rights of contributories among themselves.

3.5 Liquidator

When there is liquidation of a company, one or more persons are compulsory to be appointed specially for conducting the liquidation or winding up proceedings of the company. Such person(s) is called Liquidator(s). In case of a compulsory winding up, an official liquidator is selected by the court. In the case of a member's voluntary winding up, the liquidator is selected by the members at their general meeting. In case of a creditor's voluntary liquidation, both the members and the creditors of the company nominate the liquidator in their respective meetings if the creditors and the members nominate different persons as the liquidator, the liquidator appointed by creditors will act as liquidator. Where winding up takes place at the supervision of the court, the liquidator may be selected by the members or the creditors or by the court. The liquidator selected by the court as well as the members and creditors many together function as liquidators.

Functions of Liquidator

The liquidator is required to perform certain functions at the time of liquidation. The main functions are as follows:

1. The primary function of a liquidator is to realise the assets of the company.

2. He has to collect the money due from the contributories.

3. He has to distribute the amount realised from sale of assets and amount received from contributories in the order of preference as per Rule 329 of Companies Act.

4. He has to maintain and submit the record of receipts and payments of cash to the members in the case of voluntary winding-up and to the court in the case of compulsory winding up.

3.6 Forms of Statement of Affairs

As per section 454 of Companies Act, the directors of the company have to submit a statement of affairs of the company within 21 days of passing of the winding up order or appointment of provisional liquidator, as the case may be. The statement should be submitted to liquidator should contain the following variables as given below:

1. The assets of the company stating separately the cash balance in hand, at bank and negotiable instruments if any, held by company;
2. Company's debt and liabilities.
3. The names, addresses and professions of its creditors, stating separately the amount of secured and unsecured debts, and in case of secured debt, particulars of securities given, whether by company or an officer thereof, their value and the date on which they were given.
4. The debts to the company and names, residences, and occupations of persons from whom they are due and the amount likely to be realised on account thereof;
5. Such additional or other information as may be prescribed or as official liquidator may require.

3.7 List to be Attached with Statement of Affairs

The following list should be provided to explain the variables given in statement:

1. **List A:** This consists of all free assets. Free assets are those assets which are not specifically pledged in favour of any creditor. Assets against which there is a floating charge will also come in

this list. Calls in arrears will also come in this category to the extent they are realisable. However, uncalled capital should not be included in this list.

2. **List B:** This list consists of assets which are specifically pledged in favour of certain creditors. Any excess of the realisable value of the assets over the amount due should be shown separately as given in the prescribed form of the statement of affairs. In case of deficiency, the amount of such deficiency has to be included in List E, i.e. unsecured creditors. For example, building worth Rs. 20,000 has been mortgaged in favour of bank loan of Rs. 30,000, the bank is unsecured to the extent of Rs. 10,000 and therefore this amount will be included in list E of unsecured creditors.

3. **List C:** This List consists of preferential creditors. Preferential creditors who are unsecured but entitled to priority in payment over having a floating charge and other unsecured creditors. Subject to the provisions of Section 529A, the following are the preferential creditors which will be paid in priority to other creditors in the event of companies' winding up:

i) All revenues, taxes, cesess and rates due from the company to the Central or State Government or to local authority which have become due and payable within twelve months before the date of appointment of provisional liquidator, or otherwise the date of winding up order in case of compulsory winding up and the date of passing resolution for winding up in case voluntary winding up.

ii) All wages and salaries of any employee in respect of services rendered to the company and due for a period not exceeding four months within the said twelve months before relevant date subject to such limit as may be specified by Central Government in the Official Gazette in respect of each claimant.

iii) All accrued holiday's remuneration becoming payable to the employees or in case of his death to any other person in his right.

iv) Contribution payable to under Employee State Insurance Act 1948 or any other law for the time being in force.

v) All compensation due under' Workmen Compensation Act, 1923 in respect of death or disablement of any employee of the company.

4. **List D:** This list consists of creditors who have floating charge over the assets of the company. Usually in this list, debenture holders are included since they are generally presumed to have a floating charge over the assets of the company in the absence of any instruction in the questions.

5. **List E:** This list consists of unsecured creditors who do not have any short of charge whatsoever against the assets of the company. Trade creditors, bills payable, liabilities for bills discounted (to the extent possible loss on account of dishonour of bills), creditors on open account etc comes to this category.

6. **List F:** This consists of holders of preference shares of company. They are to be taken at a value which is left after unrealisable calls in arrears.

7. **List G:** This list consists of holders of equity share capital of the company. The due to them is to be arrived after deducting from the called up capital, any unrealisable amount of calls in arrears.

8. **List H:** This explains the reasons for surplus and deficiency as shown by statement of affairs. Earlier this list used to be in the form of ledger account. Of course, it is still termed as 'Deficiency or Surplus Account" but it is shown in the form of a statement. The period covered by this account must commence on a date not less than three years before the date of winding up order or if the company has not been incorporated, for the whole of that period , the date of formation of the company, unless the official liquidator otherwise agrees.

3.8 Liquidator's Final Statement of Account

At the time of liquidation of a company, the liquidator sale all the assets and discharge the liabilities and capital. The statement prepared to record such receipts and payments is called 'Liquidator's Final Statement of Account.' This account is prepared after fully wound-up of all the affairs of the company.

ABC Company Ltd.

LIQUIDATOR'S FINAL STATEMENT OF ACCOUNT

Receipts	***Amount***	***Payments***	***Amount***
Cash in Hand	xxx	Secured Creditors	xxx
Cash in Bank	xxx	Legal charges including	xxx
Assets Realised		(Liquidation expenses)	
Marketable Securities	xxx	Liquidator's Remuneration	xxx
Bills Receivables	xxx	Other expenses on Liquidation	xxx
Trade Debtors	xxx	Debenture Holders	
Loans and Advances	xxx	Outstanding debt on debenture	
Stock in Trade	xxx	Debentures	xxx
Work in Progress	xxx	Preferential Creditors	xxx
Plants & Machinery	xxx	Unsecured Creditors	xxx
Functions & Fixtures	xxx	Calls in advance, if any	xxx
Patents, Trademarks, etc.	xxx	Arrears of Dividend on cumulative	
Investments, etc.	xxx	Preference Shares	xxx
	xxx	Preference Shareholders	xxx

Surplus realised from Secured Creditors(if any)	xxx	Equity shareholders	xxx
Calls in arrears	xxx		
Amount received from calls on shares			

Example 1: ABC Ltd. went into voluntary liquidation. The following are details:

Assets Realised: 40,000

Liquidator's Remuneration: 5,000

Unsecured creditors: 20,000

Preference share capital is Rs. 20,000(2000 shares @10). Equity share capital consists of: 1000 shares@10, Rs. 9 called & Paid up 9000

2000 shares @ 10, Rs. 5 called & Paid up 10000

You are required to prepare the Liquidator's Statement of Account.

Solution

Liquidator's Statement of Account

Receipts	***Rs.***	***Payments***	***Rs.***
Assets Realised	40,000	Liquidator's Remuneration	5,000
Calls Made	6,000	Unsecured Creditor	20,000

		Preference Shares	20,000
		Equity Shares	1,000
Total	**46,000**	**Total**	**46,000**

Working Note

The amount of call made is calculated as follow:

Amount available for distribution among Preference Share before making call from equity share holders Rs. 15,000

Deficiency Rs. 5,000

If call made on 2,000 share @ 4 the value Rs. 8,000

Surplus after payment to preference shares Rs. 3,000

Equity shares get (3,000/3,000)

Hence, amount called from 2000 equity is (4-1) Rs. 3 = 6,000

Amount to be paid to equity shares 1,000 @ 1 = 1,000

3.8.1 Order of Payment by Liquidator

The order of payment by liquidator must in the following way:

1. Secured Creditors.
2. Legal expenses (including liquidation expenses and cost of winding up).
3. Liquidator's remuneration.
4. Payments to debenture holders and other creditors having floating charge on the assets of the company.
5. Payments to Preferential Creditors.
6. Payments to unsecured Creditors.
7. Calls in advance, if any.

8. Arrears of dividends on cumulative preference shares.

9. Amount due to preference shareholders.

10. Amount due to equity shareholders.

3.8.2 Precautions

The following points to be kept in mind while preparing the Liquidator's Final Statement of Account:

1. The words 'To' and 'By' need not be used, since it is a statement and not all account.

2. **When a Specific Asset Pledged as Security is realised By the Liquidator**

Where a specific asset is provided as security towards debentures or creditors, the amount realised on that should be used by liquidator for discharge of such debentures or creditors before making any other payment. That is, on the receipts side, the amount realised from the assets pledged, will be recorded and on the payments side, the amount payable to the secured creditors, will be recorded to the extent of amount due or amount realised whichever is less, Where the money recovered on the sale of asset pledged is less than the sum due towards secured creditors, the difference will be treated as unsecured creditors and paid after making payment to preferential creditors.

3. When a Specific Asset Pledged as Security against Debentures or Creditors is Realised by Debenture Holders or Creditors

In this case, excess if any in the hands of creditors or debenture holders must be treated as receipts and recorded on the receipts side of the statement. However, if the amount received on realisation is less than the amount due to debenture holder or creditors, it must he paid after making payment to preferential creditors. (i.e., they must be treated as unsecured creditors)

4 Calls in Arrears

Calls in arrears given in the Balance Sheet must be recovered by the liquidator from the concerned shareholders without which repayment of capital on those shares cannot be made. If the amount is not realised, the liquidator can forfeit the shares.

5 Calls on Shares

Where the amount available is not sufficient to pay outside liabilities or preference shareholders, any uncalled amount on equity shares must be called to the extent required at the relevant stage of deficiency.

6 Legal Charges and Other Expenses on liquidation

Legal expenses include stamp duty, registration expenses, legal action expenses etc. The other expenses on liquidation includes cost of liquidation like auctioneers and values charges, cost of possession and, cost of publications in Gazette and newspapers,, maintenance of estate establishment charges and other incidental expenses on liquidation, When "liquidation expenses" or "cost of winding up" is given, without stating the details, it can be shown before liquidator's remuneration.

7 Liquidator's Remuneration

Normally a fixed amount is paid to liquidator or it is paid as a percentage on assets realised by the liquidator and/or amount paid to unsecured creditors.

A. Where The Remuneration is to be paid on assets realised

The following points must be kept in mind:

(i) Until otherwise specified for calculating liquidator's remuneration, "assets realised" means any assets realised by liquidator except cash in hand and cash at bank, because cash in hand and at bank is already in the realised form and no effort is require for realising it.

(ii) Until otherwise specified, no remuneration should be paid to liquidator on calls-in-arrears and call money realised.

(iii) Surplus received from secured creditors must be considered in calculating liquidator's remuneration, since the liquidator makes an effort to realise the surplus from secured creditors.

(iv) When the problem states that remuneration is to be paid as a percentage on a 'Total amount realised', then remuneration should be calculated on total Receipts (i.e., including surplus. calls in-arrears and call money received).

B. Where The Remuneration is to be Paid on Payments Made

The following points must be kept in mind:

(I) For calculating remuneration on payment made to unsecured creditors, preferential creditors must be considered as part of unsecured creditors.

(II) Where the balance amount available is sufficient enough to pay unsecured creditors completely, liquidator's remuneration on payment to unsecured creditors will be calculated using the following formula:

$$\frac{\textbf{Amount Payable to Unsecured Creditors x Percentage of commission}}{\textbf{100}}$$

(III) When the balance amount available is 'not sufficient' enough to pay unsecured creditors completely, liquidator's remuneration on payment to unsecured creditors will be calculated using the following formula:

$$\frac{\textbf{Amount available x Percentage of commission}}{\textbf{100 + Percentage of commission}}$$

Where the liquidator has to be paid remuneration on final amount payable to shareholders, then the amount or remuneration must be calculated using the following formula:

$$\frac{\textbf{Balance amount available before making payment to shareholders x Percentage of commission}}{\textbf{100 + Percentage of commission}}$$

Example 2: Cash available before payment to unsecured creditors: Rs. 30,000

Unsecured creditors: Rs. 10,000

Share Capital: Rs. 15,000

Liquidator’s remuneration: 5 per cent of the amount distributed among shareholders.

Since the liquidator’s remuneration is to be calculated on payment persons who will be the last to get payment, it will be calculated as follows:

Cash available for shareholders: Rs. 20,000

Liquidators’ remuneration: 5 per cent of the amount distributed among the shareholders

Every payment of Rs 100 to shareholders will involve funds of Rs 105

Liquidator’s remuneration will, therefore, be Rs 20,000 X (5/105) = Rs 952

Example 3: ABC Ltd. went into liquidation with the following liabilities:

Secured Creditors	Rs 40,000(securities realised Rs 50,000)
Preferential creditors	1,200
Unsecured creditors	61,000
Liquidation expenses	500

The liquidator is entitled to a remuneration of 3% on the amount realised (including securities in the hands of secured creditors) and 1.5% on the amount distributed to unsecured creditors. The various assets (excluding the securities in the hands of the secured creditors) realised are Rs 52,000. Prepare the liquidator’s statement of account showing the payment made to the unsecured creditors.

Solution

ABC Ltd. (in Liquidation)

LIQUIDATORS’ FINAL STATEMENT OF ACCOUNT

Particulars	***Rs***	***Particulars***	***Rs***
Amount realised	52,000	Liquidation expenses	500
	10,000	Liquidator’s remuneration	3,924

Surplus from secured creditors		Preferential creditors	1,200
		Unsecured creditor(92.41% of Rs 61,000)	56,376
	62,000		62,000

Working Notes

1. Calculation of Liquidators' Remuneration:	Rs
3% of Rs 52,000 + 50,000	3,060
1.5% on Preferential creditors -1,200	18
1.5% on payments to Unsecured Creditors i.e. 57,222 X 3/203	846
	3,924

2. Payment of Unsecured creditors:

Rs 62,000 - 500 - 1, 2000 - 3,060 -18 = 57,222 -846 = Rs 56,376

8. When debentures are not secured against a specific asset, it must always be considered as secured on 'floating charge'. Hence, it must be discharged before making payment to preferential creditors.

9. **Interest on Debentures**

Any outstanding interest on debentures must be paid before discharging debenture. Interest on debentures and other loans must be paid as follows:

(i) If the company is solvent, interest must be paid up till the date or repayment of loan.

(ii) If the company is insolvent. Interest must be paid up till the date of winding up only, irrespective of when the final repayment is made.

10. Preferential Creditors

Creditor's to whom following are due will be treated as preferential creditors under Sec. 530 of the Companies Act:

(i) All revenues, taxes, cesses and rates due from the company to the Central Government or a State Government or to a local authority at the relevant date and having become due and payable within the twelve months next before that date;

(ii) Wages or Salaries (including wages payable for time or piecework and salary earned wholly or in part by way of commission) of any employee, in respect of service rendered to the company and due for a period not exceeding 4 months within the 12 months next before the appropriate date, and any reward payable to any workman under any provisions of Chapter V (a) of the Industrial Disputes Act, 1947, provided the amount payable to any one claimant does not exceed Rs. 20,000;

(iii) All accrued holiday remuneration becoming payable to any employee or in the case of his passing away, to any other person as his nominee, on the termination of his service before, or by the result of the winding up order or resolution;

(iv) Unless the company is being wound up voluntarily for reconstruction or amalgamation with another company, all sums due, in respect of employer's contributions payable during the 12 months next before the relevant date, by the employer of any individual under Employees' State Insurance Act, 1948, or any other law.

(v) All sums due as compensation, in respect of death or disablement of any employee of the company under the Workmen's Compensation Act, 1923.

(vi) All sums due to an worker, from a, pension fund, Provident Fund or any other fund for the welfare of the workers, prepared by the company; and

(vii) The expenses of any investigation held in pursuance of Section 235 or 237 in so far as they are payable by the company.

Notes: (a) Persons who advance money for the purpose of making preferential payments where (ii) and (iii) above will be treated as preferential creditors.

(b) When amount available is not sufficient to pay the preferential creditors completely, the amount so available should be distributed in proportion of amount due of each item.

Example 4: The following information was collected from the books of a limited company on 31st March, 2011 on which date a winding up order was made:

	Rs.
Equity share Capital – 20,000 shares of Rs. 10 each	2,00,000
14% Preference Share capital – 30,000 Shares of Rs. 10 each	3,00,000
Calls in arrears on equity Shares (estimated to realise Rs. 2,000)	4,000
14% first Mortgage Debentures secured by a floating charge on the whole of the assets of the company (interest paid to date)	2,00,000
Creditors having a mortgage on the freehold Land and Buildings	85,000
Creditors having a second charge on Freehold Land and Buildings	90,000
Trade Creditors	2,70,000
Bills Discounted (of these bills for Rs. 15,000 are expected to be dishonoured)	40,000
Unclaimed Dividends	6,000
Bills Payable	10,000
Income-tax due	25,000
Salaries and Wages(for five months)	40,000
Bank Overdraft secured by a second charge on the whole of the assets of the company	20,000
Cash in hand	1,200
Debtors(of these Rs. 60,000 are good; Rs. 15,000 are doubtful, estimated to realise Rs. 5,000 and the rest bad)	90,000
Bills of Exchange (considered good)	35,000
Freehold Land and Buildings(estimated to realise Rs. 1,65,000)	1,50,000

Plant and Machinery(estimated to produce Rs. 90,000	1,20,000
Fixtures and Fittings(estimated to produce Rs. 8,000)	12,000
Stock in trade(estimated to produce 25% less)	80,000
Patents (estimated to produce Rs. 45,000)	70,000

On 31st march, 2004, the company's share capital stood at the same figure as on 31st March, 2011 but in addition, there was a General Reserve of Rs. 65,000. In 2004-05 the company earned a profit of Rs 1,43,000 but thereafter it suffered trading losses totalling in all Rs. 4,67,000. In 2006-07 a speculation loss of Rs. 91,000 was incurred. Preference dividend was paid for 2004-05 and 2005-06 and on equity shares a dividend of 15% was paid for 2004-05 only. Excise authorities imposed a penalty of Rs. 1, 60,000 for evasion of excise and income tax authorities imposed a penalty of Rs. 60,400 for evasion of tax.

Prepare the Statement of Affairs and the Deficiency Account.

Solution:

The unsecured creditors of the company (List E) are the following:

Trade Creditors	2,70,000
Liability on Bills Discounted	15,000
Unclaimed Dividends	6,000
Bills Payable	10,000
One month's salaries and wages	8,000
Amount uncovered in respect of partly Secured Creditors	10,000
	3,19,000

Creditors having mortgage on Freehold Land and Buildings are fully secured since the estimated value of the security is Rs. 1,65,000 and the creditors amount to Rs. 85,000, leaving a surplus of Rs. 80,000 which the creditors having a second charge on the asset will get. These creditors, amounting to Rs. 90,000 are partly secured.

The Preferential Creditors (List C) are Rs. 25,000 due for income tax and four months' salaries and wages Rs. 32,000 or Rs. 57,000 in total.

……………………Ltd.(Liquidation)

Statement of Affairs as on March 31, 2011

	Estimated Realisable Values Rs.
Assets not specially pledged-(List A)	
Cash in hand……………………………………………………………………	1,200
Bills of Exchange……………………………………………………………....	35,000
Trade Debtors……………………………………………………………………	65,000
Unpaid Calls…………………………………………………………………….	2,000
Stock…………………………………………………………………………….	60,000
Plant and machinery……………………………………………………………	90,000
Fixtures and Fittings……………………………………………………………	8,000
Patents…………………………………………………………………………….	45,000
Assets Specifically Pledged (List B):	

Estimated Total Assets available for Preferential Creditors, Debenture holders secured by a floating charge and other creditors, brought forward.

Gross	Liabilities	Rs.
Liabilities		3,06,200
Rs.		

	(to be deducted from surplus or added to deficiency as the case may be)		
1,65,000	Secured creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged(gross liabilities only)		
57,000	Preferential Creditors (as per list C)……………................		57,000
	Estimated Balance of Asssetsavailable for Debentureholders and creditors secured by a floating charge, and unsecured creditors...		2,49,200
2,00,000	Debentureholders secured by a first floating charge (as per list D)………………………………		2,00,000
	Estimated Balance of Assets available for Bank Overdraft secured by a floating charge and unsecured creditors(as per list D)		49,200
20,000	Bank Overdraft secured by a second floating charge		20,000
	Estimated Surplus as regards Debentureholders and other creditors secured by a floating charge		29,200
	Unsecured Creditors(as per List E)		
	Estimated unsecured balance of claims of creditors partly secured on a specific asset	10,000	
2,90,000	Trade Creditors	2,80,000	
6,000	Unclaimed Dividends	6,000	
8,000	Outstanding Expenses	8,000	

15,000	Contingent liability on bill discounted	15,000	3,19,000
7,61,000	Estimated deficiency as regards creditors(being the difference between Gross assets and Gross Liabilities)		2,89,800
	Issued and called up capital:		
	30,000 14% Preference shares of Rs.10 each fully paid(as per list F)	3,00,000	
	20,000 Equity shares of Rs. 10 each fully paid less calls in arrear (as per list G)	1,98,000	4,98,000
	Estimated Deficiency as regards Members		7,87,800

				Rs.3,06,200
Gross Liabilities Rs.	*Liabilities*			
	(to be deducted from surplus or added to deficiency as the case may be)			
1,65,000	Secured creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged(gross liabilities only)			57,000
57,000	Preferential Creditors (as per list C)……………...............			
	Estimated Balance of Assets available for Debentureholders and creditors secured by a floating charge, and unsecured creditors*..			2,49,200
2,00,000	Debentureholders secured by a first floating charge (as per list D)………………			2,00,000
	Estimated Balance of Assets available for Bank Overdraft secured by a floating charge and unsecured creditors(as per list D)			
20,000	Bank Overdraft secured by a second floating charge			49,200
	Estimated Surplus as regards Debenture holders and other creditors secured by a floating charge			20,000
	Unsecured Creditors(as per List E)			29,200
	Estimated unsecured balance of claims of creditors partly secured on a specific asset	10,000		
2,90,000	Trade Creditors		2,80,000	
6,000	Unclaimed Dividends		6,000	
8,000	Outstanding Expenses		8,000	
15,000	Contingent liability on bill discounted		15,000	3,19,000
7,61,000	Estimated deficiency as regards creditors(being the difference between Gross assets and Gross Liabilities)			2,89,800
	Issued and called up capital:			
	30,000 14% Preference shares of Rs.10 each fully paid(as per list F)		3,00,000	
	20,000 Equity shares of Rs. 10 each fully paid less calls in arrear (as per list G)		1,98,000	4,98,000
	Estimated Deficiency as regards Members			7,87,800

List H – Deficiency Account

A. Items contributing to Deficiency:-

			Rs.
1.	Excess of Capital and Liabilities over Assets on 1st April,2004 as shown By the Balance Sheet(copy attached)		Nil
2.	Net dividends and bonuses declared during the period from 1st April,2004 to 1st march,2010		1,13,400
3	Net trading losses after charging depreciation, taxation, interest on debentures, etc.		4,67,000
4	Losses other than trading losses written off or for which provision has been made in the books during the same period:	Rs.	
	Speculation Loss	91,000	
	Penalty imposed by Excise Authorities	1,60,000	
	Penalty imposed by Taxation Authorities	60,400	3,11,400
5.	Estimated losses now written off or for which provision has been made for the purpose of preparing the statement:		
	Plant and Machinery	30,000	
	Fixtures and Fittings	4,000	
	Stock in Trade	20,000	
	Patents	25,000	
	Book Debts	25,000	

	Bills Discounted…………………………………………………………	15,000	1,19,000
6.	Other items contributing to Deficiency		Nil
	Total (A)		10,10,800
B.	Items reducing Deficiency :-		
7.	Excess of assets over capital and liabilities on 1st April,2004 as shown in the Balance Sheet(copy annexed)		65,000
8.	Net trading profits(after charging depreciation, taxation, interest on debentures, etc.) from 1st April,2004 to 31st March,2010		1,43,000
9.	Profits and income other than trading profits during the same period		Nil
10.	Other items reducing Deficiency—profit expected on realisation of Freehold Land and Buildings		15,000
	Total(B)		2,23,000
	Deficiency as shown by the Statement of Affairs(A---B)		7,87,800

11. **Calls Paid in Advance**

Calls paid in advance by shareholders must be paid immediately after paying unsecured creditors.

Example 5: Share capital 1,000 equity shares of Rs 10 each, Rs 8 called and paid-up: 8,000

Calls in advance on 100 shares @ Re 1 per share Rs 100

In case the company has a sum of Rs 300 available for distribution among the shareholders of the company, Rs 100 must be returned in priority to those shareholders who have paid calls in advance. The balance of Rs 200 will be distributed among all the shareholders proportionately.

12. **Preference Dividend**

(i) Preference dividend declared but not paid must be treated as "unsecured creditors" and paid accordingly.

(ii) In case of cumulative preference shares, if dividends are in arrears for one or more years, but not declared, then, it must be paid before paying preference share capital.

13. Where the preference shares are participating preference shares, the balance available after paying preference share capital and equity share capital, must be proportionately distributed to both preference shareholders and equity shareholders.

14. When share capital of the company includes fully paid shares and partly paid shares, the difference amount must be paid first on fully paid shares and balance if any, must be proportionately distributed.

Example 6: The following information is available of Garg Ltd.

Garg Ltd
Balance Sheet
as on 31 st March, 2012

Liabilities	Amt	Assets	Amt
1000,6% Pref Shares @100	100000	Machinery	190000
2000 Equity shares @100	200000	Furniture	10000
2000 Equity Shares @100 Rs. 75 paid	150000	Stock	120000
Loan(Secured on Stock)	1,00,000	Debtors	240000
Creditors	3,50,000	Cash at bank	50000
Income Tax Payable	10,000	Profit & Loss a/c	300000

Total	9,10,000	Total	9,10,000

The company went into liquidation on 1st April 2012. The assets were realised as the follows:

Machinery	1, 66,000
Furniture	8000
Stock	1, 10,000
Debtors	2.30,000
Liquidation Exp	4000

The liquidators are entitled to a commission at 2% on amount paid ton unsecured creditors excluding preferential creditors. Calls on partly paid shares were made but the amounts due on 200 shares were found to be irrecoverable. Prepare liquidators statement of account.

Solution: In the books of Garg Ltd.

LIQUIDATORS FINAL STATEMENT OF ACCOUNT

Receipts	Amount	Payments	Amount
Cash at Bank	50,000	Liquidation exp	4000
Machinery	1,66,000	Liquidators commission	7000
Furniture (110000-100000)	8000	Income tax payable	10,000
Stock	10000	Unsecured creditors	3,50,000
Debtors	2,30,000	Preference shareholders	100,000
Call on shares 1800 shares @ 15	27000	Final Payment to equity 2000@10	20000

	4,91.000	**4,91,000**

Working Note

1. Computation of call on shares

Total payment excluding final payment to equity	471000
Less: Total Receipts except call Money	(464000)
Surplus/ deficit	7000
Add: Notional Amount of call 1800X 25	45000
	Total =38000

Notional surplus per share 38000/3800=10

Hence call on partly paid 25-10=Rs.15 Per share.

3.9 Summary

Liquidation or the winding up of a company means the termination of the legal existence of a company. Under such circumstances, the assets of the company are disposed off and the debts are paid, out of the amount realized from assets or from the contributions made by the members and the surplus if any is distributed among members in proportion to their holding. There are two models of liquidation of a company i.e. a) Winding up by National Company law Tribunal and b). Voluntary winding up: (i) Member's voluntary winding up (ii) By creditors. At the time of liquidation of a company, the liquidator realises all the assets and discharge the liabilities and capital. The statement prepared to record such receipts and payments is called 'Liquidator's Final Statement of Account.' This statement is prepared after the affairs of the company are fully wound-up.

3.10 Keywords

Liquidation: A process by which dissolution of a company is brought about and its properties administered for the benefit of its creditors and members.

List 'B' Contributories: A list of those persons who were members of company during the 12 months preceding the date of winding up.

Compulsory Winding up: The winding of company by order of court.

Preferential Creditors: These are the creditors which are paid in priority to all other debts.

Statement of Affairs: A statement submitted by directors to the liquidator regarding details of assets and liabilities of company.

3.11 Review Questions

1. Differentiate between winding up of company and dissolution of company. Explain various method of winding up.

2. What are preferential creditors? State the various types of preferential creditors in the event of the company's winding up.

3. Insol Ltd is to be liquidated. Their summarised balance sheet as at 30th September, 2012, is as follows:

BALANCE SHEET

as at 30th September, 2012

Liabilities	Rs.	Assets	Rs.
2,50,000 Equity Shares@ 10	25,00,000	Machinery	45,000
Provisions for bad Debts	15,000	Leasehold Properties	60,000
Debentures	75,000	Stock in Trade	1,500
Bank Overdraft	27,000	Book Debts	90,000

Liabilities for Purchase	30,000	Investments	9,000
	2,67,000	Call-in-Arrear	7,500
		Cash in Hand	1,500
		Profit & Loss A/c	52,500
	2,67,000		2,67,000

Contingent liabilities are:

For bill discounted Rs. 1, 00,000

For excise duty demand Rs. 1, 50,000

On the investigation, it is found that the contingent liabilities are certain to devolve and that the assets are likely to be realised as follows:

Land and Buildings Rs. 11, 00,000

Other Fixed Assets Rs. 18, 00,000

Current Assets Rs. 35, 00,000

Taking the above into account prepare statement of affairs.

3. Mr. Been is appointed liquidator of Moon Company Ltd., in voluntary liquidation, on 1 July 2010. Following balances are extracted from the books on that date:

BALANCE SHEET

as at 1st July, 2010

Liabilities	Rs.	Assets	Rs.
24000 Shares @5	1,20,000	Machinery	45,000
Provision for Bad Debts	15,000	Leasehold Properties	60,000
Debentures	75,000	Stock in Trade	1,500

Bank Overdraft	27,000	Book Debts	90,000
Liabilities for Purchase	30,000	Investments	9,000
		Call in Arrear	7,500
		Cash in Hand	1,500
		Profit and Loss A/c	52,500
Total	**2,67,000**	**Total**	**2,67,000**

You are requested to prepare a statement of affairs and deficiency/ surplus account to be submitted to the meeting of the creditors. The following assets are valued as under:

Machinery	Rs. 90,000
Leasehold Properties	Rs. 1, 09,000
Investments	Rs. 6,000
Stock in trade	Rs. 3,000

Bad debts are Rs. 3,000 and the doubtful debts are Rs 6,000 which are estimated to realise Rs. 3000. The bank overdraft is secured by deposit of title deeds of leasehold properties. Preferential creditors are Rs. 15, 00 Telephone rent outstanding Rs. 120.

3.12 Further Reading

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.

2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.

3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.

4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.

5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

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Lesson-4

ACCOUNTING FOR HOLDING COMPANIES

4.0 Objectives

After going through this chapter, the student will be able to:

1. understand the concept of holding company;
2. understand appropriate adjustment entries of holding company and
3. preparation of consolidated Balance Sheet and P & L A/c.

4.1 Introduction

One of the popular firms of business combination is by means of holding company or parent Company. A holding company is one which indirectly or directly acquires either all or more than half the number of equity shares in one or more companies so as to secure a controlling interest in such companies, which are then called subsidiary companies. Holding companies are able to appoint the majority of the directors of subsidiary company and therefore, control such companies. The company is called as subsidiary company in which holding company acquired the majority shares.

4.2 Meaning and Definition

According to Section 4 of the Companies Act, 1956, a company is called subsidiary of another if and only if –

a) That other company controls the appointment of its Board of Directors;

i) Where the 1st mentioned company is an existing company in respect of which the holders of preference shares issued before the commencement of this Act have the same voting rights in all respect as the holders of equity shares exercises or controls more than half of the total voting power of such company.

ii) Where in the first mentioned company, any other company, holds more than fifty per cent in nominal value of its Equity share capitals.

ii) The company is a subsidiary of any company which is subsidiary of that other company.

4.3 Consolidation of Financial Statement

AS-21 comes into effect in respect of accounting periods commencing on or after 1st April 2001 i.e. for year ending 31st March, 2002. The AS 21 is related to all the enterprises that prepare consolidated financial statement. It is compulsory for listed companies and banking companies.

As per AS 21, the consolidated financial statements would include:

i) Profit & Loss A/c

ii) Balance sheet

iii) Cash flow statement

iv) Comments of accounts except typical remarks

v) Segment reporting

AS 21 also desire use of various important terms, as well as treatment, while preparing consolidated financial statement. Consolidated statements must be prepared for both domestic as well as foreign subsidiaries.

4.3.1 Consolidated Profit And Loss Account

The Consolidated Profit and Loss Account of the holding company and its subsidiaries are prepared to show the operating activities of the companies comprising the groups. While preparing the Consolidated Profit and Loss account of the holding company and its subsidiary, the items appearing in the profit and loss account of the holding company and the subsidiary companies have to be aggregated. But while doing so, the following adjustments have to be made.

1) Prepare Profit and Loss Account in columnar form amounts relating to inter-company transactions are entered in the adjustment column against the respective items and are subtracted while entering amounts in the total columns.

2) All inter company operating transactions are eliminated such as purchase and sale of goods, interest on loans among the group companies.

3) All inter company profits are adjusted.

4) Dividends received from the subsidiary company by the holding company should be eliminated from both the sides of Consolidated Profit and Loss Account.

5) Interest accrued and outstanding on debenture of the subsidiary company held by the holding company should be accounted by holding and subsidiary company both and then it should be eliminated.

6) Readjustment of depreciation on revaluation on fixed Assets at the time of acquisition of shares by the holding company should be adjusted in consolidated balance sheet and respective fixed assets and in the consolidated profit and loss account.

7) The minority interest in the profit of subsidiary company should be transferred minority interest account, in the proportion of total profit after adjustment of revaluation of fixed Assets, but before adjusting unrealized profit on stock.

8) The share of holding company in pre-acquisition profit should be transferred to cost of control, in case shares are acquired during the year.

9) Share of holding company in the past acquisition profits shall be considered as revenue profits.

10) The balance in holding company columns will represents the total profit or loss made or suffered by the group as a whole.

Example: 1 The summarised Profit and Loss A/c of H industries Ltd. and its subsidiaries S Mills Ltd. and S Dyestuffs Ltd. for the year ended on 31 march, 2012 were as follows:

Particulars	***H Industries Ltd.***	***S Mills Ltd.***	***S Dyestuffs Ltd.***
	Rs	***Rs***	***Rs***
Balance brought forward	10,00,000	6,00,000	-
Trading profits	88,60,000	25,20,000	2,00,000
Interim Dividend received from S Mills Ltd.	3,20,000	-	-
Directors' Fees from S Dyestuffs Ltd.	20,000	-	-
Balance carried forward	-	-	-
	1,02,00,000	31,20,000	6,26,000
Balance brought forward	----	----	4,00,000
Directors' Fees	80,000	40,000	30,000
Depreciation	4,00,000	3,60,000	1,80,000
Audit Fees	30,000	20,000	16,000
Provision for Taxation	47,60,000	14,40,000	----
Transfer to Reserves	1,00,000	----	----
Shares in S Dyestuffs written off	1,60,000	----	----
Proposed Dividends	30,00,000	----	----
Interim Dividend	----	4,00,000	----
Balance carried forward	16,70,000	8,60,000	----
	1,02,00,000	31,20,000	6,26,000

Paid up Capital:

Equity shares of Rs 100 each	50,00,000	20,00,000	16,00,000

You also ascertain the following facts:

1. H Industries Ltd. acquired the following shares:

S Mills Ltd.	12,000 shares on 1 April, 2010
	4,000 shares on 1 April, 2011
S Dyestuffs Ltd.	12,000 shares on1 April, 2012

2. Profit and Loss A/c of S Mills Ltd. had a debit balance of Rs 8, 00,000 0n April 1, 2010.
3. Profit and Loss A/c of S Dyestuffs Ltd. showed a credit balance of Rs. 80,000 as on 1 April, 2011.
4. During the year, H industries Ltd. purchased goods from S Mills Ltd. on which S Mills Ltd. recorded profit of 33.5 per cent on cost to S Mills Ltd. for Rs 4, 00,000, at a valuation of Rs3, 80, 000.

You are required to prepare a consolidated Profit and Loss A/c of H Industries Ltd. and its subsidiaries.

H industries Ltd. and Subsidiaries, S Mills Ltd. and S Dyestuffs Ltd.

CONSOLIDATED PROFIT AND LOSS ACCOUNT

For the year ended 31 March, 2012

Particulars	***H Industries Ltd.***	***S Mills Ltd.***	***S Dyestuffs Ltd.***	***Total***	***Adjustment***	***Net***
Debit						
To Balance b/d	----	----	4,00,000	4,00,000	4,00,000	----
To Directors’ Free	80,000	40,000	30,000	1,50,000	20,000	1,30,000
To Audit Fee	30,000	20,000	16,000	66,000	----	66,000
To Depreciation	4,00,000	3,60,000	1,80,000	9,40,000	----	9,40,000
To Provision for taxes	47,60,000	14,40,000	-----	62,00,000	----	62,00,000
To Shares in						
S Dyestuffs w/o	1,60,000	----	----	1,60,000	----	1,60,000
To interim Dividend						
To Proposed Dividend	----	4,00,000	----	4,00,000	3,20,000	80,000
To Transfer to Reserve						
To Stock Reserve	30,00,000	----	----	30,00,000	----	30,00,000
To Minority Interest						
To Cost of Control	1,00,000	----	----	1,00,000	----	1,00,000
To Balance of Profit c/d						
	----	80,000	----	80,000	----	80,000
	----	1,72,000	----	1,72,000	----	1,72,000
Credit						
By Balance b/d						
	----	----	60,000	60,000	----	60,000
By Trading Profit						
By Interim Dividend						
	16,70,000	9,68,000	-----	26,38,000	3,79,500	22,58,500
By Directors’ Fees						
By Minority Interest	1,02,00,000	34,80,000	6,86,000	1,43,66,000	11,19,500	1,32,46,500
By Cost of Control						
By Balance c/d						
	10,00,000	6,00,000	------	16,00,000	4,00,000	12,00,000
	88,60,000	25,20,000	2,00,000	1,15,80,000	----	1,15,80,000
	3,20,000	-----	----	3,20,000	3,20,000	-----

20,000	----	----	20,000	20,000	-----
----	----	1,06,500	1,06,500	-----	1,06,500
----	3,60,000	-----	3,60,000	-----	3,60,000
-----	-----	3,79,500	3,79,500	3,79,500	----
1,02,00,000	34,80,000	6,86,000	1,43,66,000	11,19,500	1,32,46,500

Working Notes

(i) Minority Interest :

S Dyestuff Ltd. ¼ of Rs 4,26,000(Dr.)	Rs 1,06,500
S Mills Ltd.1/5 of Rs 8,60,000	1,72,000

(ii) Cost of Control

S Dyestuffs Ltd. 12/16 of Rs.80, 000 profit existing on1 April, 2008	60,000
S Mills Ltd.	
Capital Loss: 12/20 of Rs 8, 00,000 loss existing on 1 April, 2007	4, 80,000
Capital Profit: Pertaining to 4,000 shares acquired on 1 April, 2009	
1/5 of Rs 6, 00,000 (credit balance on that date)	1, 20,000
	3, 60,000

(iii) Stock Reserve:

Unrealised profit on stock of Rs 4, 00,000 x (1/4)	1, 00,000
Less: Amount already provided by writing down stock	20,000
	80,000

It is also possible to create stock reserve equal to Rs. 60,000 after excluding minority's interest, i.e., 80 per cent 1, 00,000 less amount already provided. However AS 21 does not permit it.

4.3.2 Preparation of Consolidated Balance Sheet

The following points need special attention while preparing consolidated balance sheet. 1) Share of minority (outside shareholders) and Share of holding company 2) Date of Balance sheet of holding company and that of various subsidiary companies must be matching. If they are not so essential adjustment must be made before consolidation. 3) Date of acquisition of control in subsidiary companies. 4) Inter-company owing. 5) Depreciation, revaluation of fixed assets as on date of acquisition and adjustment on revaluation amount etc.

Consolidation Procedure

In order that the consolidated financial statement presents financial information about the group as that of single enterprises, that following steps should be taken:

1. The cost to the parent of its investment in each subsidiary and the parent's portion of equity of each subsidiary at the date on which investment is made in all subsidiary, should be eliminated.
2. Any excess to cost to the parent of its investment in subsidiary over the parent portion of equity in subsidiary on which the investment is made should be presented as goodwill in consolidated accounts.
3. When the cost of investment of parent company is less than the parent portion of equity in subsidiary on the date of investment the difference should be treated as capital reserves.
4. Minority interest in the net income of consolidated subsidiaries for the reporting period should be identified and adjusted against the income of group in order to arrive at the net income attributable to the owners of the parent.
5. Intra group balances and intragroup transaction and resulting unrealised profit should be eliminated in full.
6. In addition to the above said information, a list of all subsidiaries including name, country and share of ownership etc should be prepared.
7. Comparative figures for the previous period should be presented in the consolidated statements.

Example 2: From the following balance sheet of H Ltd. and its subsidiary S Ltd., prepare a consolidated balance sheet.

BALANCE SHEET

As on 31 December, 2011

Liabilities	*H Ltd. Rs*	*S Ltd. Rs*	*Assets*	*H Ltd.*	*S Ltd.*
Share capital (in shares of Rs 10 each)	20,000	10,000	Sudry Assets	20,000	15,000
Sundry Liabilities	10,000	5,000	Investments in shares of S Ltd.(1,000 shares)	10,000	
	30,000	15,000		30,000	15,000

Solution

In the present case H Ltd. holds the whole of the share capital of S Ltd. In other words s Ltd. is the wholly owned subsidiary of H Ltd. the amount of Rs 10,000 paid by H Ltd. entitles it to the whole of the assets and makes liable for the whole of the liabilities of S Ltd. It will, therefore appropriate to prepare a consolidated balance sheet to give a complete picture about the assets and liabilities of H Ltd. and subsidiary S Ltd. The Investments Account in the books of H Ltd. will be replaced by the assets and liabilities of S Ltd. as shown below in the consolidated balance sheet:

CONSOLIDATED BALANCE SHEET

Liabilities		Rs	Assets		Rs
Share Capital of H Ltd.		20,000	Sundry Assets:		
Sundry Liabilities:			H	20,000	
H	10,000		S	15,000	35,000
S	5,000	15,000			
		35,000			35,000

4.4 Minority Interest

The claim of outside shareholders in the subsidiary company has to be assessed and shown as liability in the consolidated balance sheet. Interest of minority in the net assets of the company is nothing but the proportionate reserve surpluses funds share of aggregation of share capital etc. proportionate share of all assets should be deducted from the minority interest. Thus, interest of minority is the share of outsider in the following.

1) Share in share capital in subsidiary.

2) Share in reserves (both pre and post-acquisition of subsidiary).

3) Share in accumulated losses should be deducted.

4) Proportionate share of profit or loss on revaluation of assets.

5) Preference share capital of subsidiary company held by outsiders and dividend due on such share capital, if there are profits.

Minority interest means interest of outsiders. It is treated as obligation and shown in consolidated balance sheet as current liability. This amount is fundamentally intrinsic value of shares held by minority.

Example:3 The following is the Balance sheet of S Ltd. as on 31st March, 2012.

BALANCE SHEET OF S LTD.
as on 31st March, 2012

Liabilities	**Amount**	**Assets**	**Amount**
Equity Shares @ Rs. 10	2,70,000	Fixed Assets	2,90,000
General Reserve Profit & Loss A/c	3,60,000	Investment	2,75000
Current Liabilities	8,5000	Current Assets	1,30000
		Preliminary Expenses	20,000
Total	**7,15,000**	**Total**	**7,15,000**

H Ltd. acquired 25,000 shares in S Ltd. on 31st March, 2012 at a cost of Rs.75, 000. Fixed assets were revalued at Rs 3, 28,000. Calculate minority interest.

Solution

Minority Interest 2,000/27,000= 2 / 27

Minority Interest	Rs
1) Share in share capital: 2, 70,000 X 2/27	= 20,000
2) Share in Reserves and Surpluses	= 20,000
3, 60,000 X 2 / 27	
3) Share in capital profits	
Profit on appreciation on fixed Assets	
(3, 60,000 – 20,000 + 38,000)	
= 3, 78,000 X 2 /27	= 28,000

Minority Interest	68,000
	=========

4.5 Cost of Control / Goodwill / Capital Reserve

The holding company acquires more than 50% of the shares of the subsidiary company. These shares may be acquired at a market price. Which can be at a discount or premium? This amount will be recorded in the balance sheet of holding company of the assets side as investment in the shares of subsidiary company. This will be equal to the price paid for shares in net assets of subsidiary company as on date of its acquisition. Net assets of the subsidiary company consist of share capital, reserve after adjustment and accumulated profits, accumulated losses as on the date of acquirement. If the sum paid by the holding company for the shares of subsidiary company is more than its proportionate share in the net asset of the subsidiary company as on the date of acquirement, the variation is considered as goodwill. If there is surplus of proportionate share in net assets of subsidiary company intrinsic of shares acquired and cost of shares acquired by holding company there will be capital reserve in favour of holding company. It goodwill already present in the balance sheet of holding company or both the goodwill thus calculated, will be added up to the present goodwill. Capital Reserve will be deducted from Goodwill. In short, net sum resulting from goodwill and Capital Reserve will be shown in the consolidated Balance sheet.

Example:4 Cost of Control / Goodwill: Balance sheet of S Ltd. as on 31st March 2010 (Liabilities only)

Rs.

Share capital 40,000 Equity shares of Rs. 10/- each	4, 00,000
Reserves and surpluses	2, 50,000
Secured loan	2, 50,000
Other Liabilities	1, 00,000

	10, 00,000
	==========

On the above date H Ltd. acquired 30,000 equity shares in S Ltd. on the above date for Rs 7, 50,000 fixed assets of S Ltd. were appreciated by Rs. 1, 50,000 find out cost of control / goodwill.

Solution

	Rs.	Rs.
Cost of investment in S Ltd.		7, 50,000
Less: 1) Share in share capital 4, 00,000 X ¾	= 3, 00,000	
2) Share in Reserves and surpluses		
Capital profit 2, 50,000 X ¾	= 1, 87,500	
Share in capital profit		
(Appreciation in fixed assets) 1, 50,000 X ¾	= 1, 12,500	6, 00,000

	Goodwill	1, 50,000
		=======

Suppose in above case, cost of investment amounted to Rs.5,00,000 then instead of goodwill, there would be capital Reserve, Rs. 1,00,000.

4.6 Capital Profits and Revenue Profits

The holding company may acquire the shares in the subsidiary company either on the balance sheet date or any date earlier than the date of balance. All the income earned by the subsidiary company till the date of acquisition of shares by holding company has to be taken as capital profits for the holding company. Such reserves lose their individual identity and considered as capital profits. In case, the parent company acquired shares on a date other than balance sheet date of subsidiary, the income of subsidiary company will have to be apportioned between capital profits and revenue profits from the point of view of the holding company. Thus any income earned by subsidiary company before the date of acquisition is the capital profit, while any income earned by subsidiary company after the date of acquisition is revenue income. At the time of preparing the consolidated balance sheet share in capital profits should be adjusted with the cost of control and revenue profits / reserves should be merged with the balances in the reserve and surpluses of the holding company.

Example 5: On 31st March, 2012, the balance sheets of Major Ltd. and its subsidiary Minor Ltd. stood as follows:

Liabilities	***Major Ltd.(Rs)***	***Minor Ltd. (Rs)***
Equity share capital	8,00,000	2,00,000
General reserves	1,50,000	70,000
Profit and loss Account	90,000	55,000
Creditors	1,20,000	80,000
	11,60,000	4,05,000
Assets:		
Fixed assets	5,50,000	1,00,000
75% Shares in Minor Ltd.(at cost)	2,80,000	-----
Stock	1,05,000	1,77,000
Other current assets	2,25,000	1,28,000
	11,60,000	4,05,000

Draw a consolidated balance sheet as at 31st March, 2012 after taking to consideration the following information**:**

(i) Major Ltd. acquired the shares on 31st July, 2011.

(ii) Minor Ltd. earned a profit of Rs 45,000 for the year ended 31st March, 2012.

(iii) In January, 2012, Minor Ltd. sold to Major Ltd. goods costing Rs 15,000 for Rs.20, 000. On 31st March, 2012, half of these goods were lying as unsold in the godowns on Major Ltd.

Solution

CONSOLIDATED BALANCE SHEET OF MAJOR LTD. AND ITS SUBSIDIARY MINOR LTD.

As on 31st March, 2012

Liabilities		*Rs.*	*Assets*		*Rs.*
Equity share Capital		8,00,000	Goodwill(WN 4)		58,750
Minority interest(WN5)		81,250	Other fixed assets:		
General reserve		1,50,000	Major Ltd.	5,50,000	
Profit and Loss Account:			Minor Ltd.	1,00,000	6,50,000
Major Ltd.	90,000		Stock:		
Add: Share in			Major Ltd.	1,05,000	
Minor Ltd. profit	22,500		Minor Ltd.	1,77,000	
	1,12,500			2,82,000	
Less: Unrealised profit	2,500	1,10,000	Less: Unrealised profit(WN3)	2,500	2,79,500
Creditors:			Other current assets:		
Major Ltd.	1,20,000		Major Ltd.	2,25,000	
Minor Ltd.	80,000	2,00,000	Minor Ltd.	1,28,000	3,53,000
		13,41,250			13,41,250

Working Notes

(1) Computation of Capital Profits

	Rs.
General Reserve	70,000
Profit and Loss account balance as on 31st March,2011	10,000
(Rs.55,000- Rs. 45,000)	
Current year's profit upto 31st July,2011	
(Rs. 45,000 X4/12)	15,000
	95,000

Share of Major Ltd. = Rs. 95,000 x 75/100 = Rs.71, 250

Minority shareholders' share = Rs. 95,000 x 25/ 100 = Rs.23, 750

(2) Computation of Revenue Profits

Profits from Ist August, 2011 to 31st March, 2012 i.e. for 8 months

=Rs. 45, 0000 x 8/12 =Rs. 30,000

Major Ltd.'s share = Rs. 30,000 x 75/100 = Rs. 22,500

Minority shareholders' share = Rs. 30,000 x25/100 = Rs. 7,500

(3) Unrealised profit in respect of stock with Major Ltd.

Total profit charged by Minor Ltd. = Rs. 20,000 – Rs. 15,000 =Rs. 5,000

Since only half of the goods remained unsold as on 31st March, 2012, the unrealised profit = Rs. 5,000 x ½ = Rs. 2,500

It is desirable to treat, the entire profit of Rs. 2,500 as unrealised profit in view of the latest Accountant Standard (AS-21) "Consolidated Financial Statements".

(4) Cost of Control (or Goodwill)

	Rs.	Rs.
Amount paid for acquiring 75% share of Minor Ltd.		2, 80,000
Less: Paid up value of 75% share of Minor Ltd.	1, 50,000	
H Ltd.'s chare of capital profits	71,250	2, 21,250
Cost of control (Goodwill)		58,750

(5) Minority Interest:

	Rs.
Paid up value of 25% shares of Minor Ltd.	50,000
Add: Share in capital profits	23,750
Share in revenue profits	7,500
	81,250

4.7 Unrealized Profit

The problem of unrealized profit arises in those cases where the companies of the same group have sold goods to each other at the profits and goods still remain unsold at the end of the year company to whom the commodities are sold. While preparing the consolidated balance sheet, unrealized income has to be eliminated from the consolidated balance sheet in the following manner:

1. Unrealised profits should be deducted from the current revenue profits of the holding company.
2. The same should be deducted from the stock of the company consolidated balance sheet outsiders will not be affected in any way due to unrealized profits.

Example 6: The stock in trade of S Ltd. includes Rs. 60,000 in respect of stock purchased from H Ltd. These items have been sold by H Ltd. at a profit of 20% on invoice price.

Therefore, unrealized profit = 60,000 x 20/100=12,000

Unrealized profit Rs. 12,000 should be deducted from closing stock in the consolidated balance sheet and from revenue profits i.e. P & L A/c.

4.8 Contingent Liabilities

AS- 29 defines the contingent liability as a possible obligation that arises from past events and whose existence will be confirmed only by occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from the past events but not recognized / provided. Such contingent liability may be of two types.

a) External contingent liability.

b) Internal contingent liability.

Internal contingent liability relates in respect of transactions between holding and subsidiary company and it will not be shown as foot note in the consolidated balance sheet, as they become visible as real liability in the consolidated balance sheet.

Example 7: H Ltd. acquires 4,000 shares of Rs 10 each at Rs 15 per share in S Ltd. on 1 October, 2012. The issued share capital of S Ltd. consists of 5,000 shares of Rs 10 each. In 1992, S Ltd. declares a dividend of 20 per cent on its paid up capital for the year ending 31 December, 2012. The profit and loss account of S Ltd. shows the following position:

	Rs
Profit and Loss A/c Balance on 1January, 2012	30,000
Profit for the year (2012)	18,000

Journalise the transactions in the books of H Ltd. taking different possibilities on receipt of dividend.

Solution

Basic calculation profits:	Rs
Pre-acquisition profits:	30,000
Balance of Profit and Loss A/c on January, 2012	18,000
Profit for 9 months (pre-acquisition) of 2012	48,000
Post-acquisition profits:	
Profit for 3 months (post-acquisition) of 2012 24,000 x (1/4)	6,000
Dividends payable by S Ltd.	
Total Dividend (50,000x 20/100)	10,000
Share of holding company in total dividend 10,000 x 4/5	8,000

The following are the journal entries in the books of H Ltd. under different alternatives.

1. When entire amount of dividend is paid out of pre-acquisition profits

		Dr.	Cr.
Bank A/c	Dr.	8,000	
To Investment A/c			8,000

2. When post-acquisition profits are first used

   Since the post-acquisition profits are not entirely sufficient for meeting the dividend's payment, the company may first use the post- acquisition profits and later the pre-acquisition profits. In such case, the following entry may be passed:

		Dr.	Cr.
Bank A/c	Dr.	8,000	
To Investment A/c (4/5 x 4,000)			3,200
To Profit and Loss A/c (4/5 x 6,000)			4,800

3. When profits of 2012 are used

   The profits for 2012 amount to Rs 24,000 out of which pre-acquisition profits are Rs. 18,000 and post-acquisition profits are Rs 6,000. In case dividend for 2012 is presumed to have been paid out of 1991 profits, the dividend received by H Ltd. from pre- and post-acquisition profits will be as follows:

   6,000/24,000 x 8,000 = Rs 2,000 out of post-acquisition profits.

   18,000/ 24,000 x 8,000 = Rs 6,000 out of pre-acquisition profits.

   The following journal entry will be passed:

		Dr.	Cr.
Bank A/c	Dr.	8,000	
To Investment A/c			6,000
To Profit and Loss A/c			2,000

4. When total profits have been proportionately used:

   In such a case S Ltd. should have received dividend out of pre- and post-acquisition profits as follows:

   Out of pre-acquisition profits

   8,000 x 48,000 / 54,000 Rs 7,111

Out of post-acquisition profits

8,000 x 6,000/ 54,000 889

The following journal entry for receipt of dividend will be passed:

Bank A/c	Dr.	8,000	
To Investment A/c			7,111
To Profit and Loss A/c			899

4.9 Treatment of Dividend

i) Dividend Paid

When subsidiary company pays dividend, the parent company will naturally receive its due share. On receipt the parent company will debit bank account. Which account to be credited, it depends upon whether dividend received out of pre-acquisition profit or out of post-acquisition profit. Dividend received by the parent company out of Pre-acquisition profit should be credited to investment account. If the dividend is out of post-acquisition profit only than it should be treated as revenue income and credited to profit and loss account.

ii) Proposed Dividend

In case the auxiliary company has planned dividend on its shares which is not accounted by the holding company for such dividend due on their investment in subsidiary company profits Profit may be then analysed between capitals revenue in the usual manner.

iii) Dividend Payable

In case subsidiary company has declared dividend and the holding company taken credits for such dividend in its account, following treatments should be given:

1. No adjustment in respect of such dividend should be done in the subsidiary company book.
2. In the holding company books dividend out of pre-acquisition profit should be credited investment account. Dividend paid out of profit after acquisition should be credited to Profit and Loss Account.
3. In the consolidated balance-sheet the amount of dividend payable by the subsidiary company will be cancelled against the amount of dividend receivable by the holding company. Dividend payable to minorities may be either included in the minority interest or be shown separately as liability in the consolidated balance sheet.

IV) Intension to Propose Dividend

In case, subsidiary company intends to propose dividend, such proposed dividend given in adjustment may be completely ignored while preparing the consolidated balance sheet. Alternatively proposed dividend on share capital held by minority may be deducted from minority's interest and shown separately liability in the consolidated balance sheet.

Consolidated Profit and Loss Account

The consolidated profit and loss account of the holding company and its subsidiaries are prepared to show the operating activities of the companies comprising the groups. While preparing the consolidated profit and loss account of the holding company and its subsidiary, the items shown in the profit and loss account of the parent company and the subsidiary companies have to be aggregated. But while doing so, the following adjustments have to be made:

1) Prepare Profit and Loss Account in columnar form Amounts relating to intercompany transactions are entered in the adjustment column against the respective items and are subtracted while entering amounts in the total columns.

2) All inter company operating transactions are eliminated such as purchase and sale of goods, interest on loans among the group companies.

3) All inter company profits are adjusted.

4) Dividends received from the subsidiary company by the holding company should be eliminated from both the sides of consolidated Profit and Loss Account.

5) Interest accrued and outstanding on debenture of the subsidiary company held by the holding company should be accounted by holding and subsidiary company both and then it's should be eliminated.

6) Modification of depreciation on revaluation of fixed assets at the time of acquisition of shares by the parent company should be adjusted in consolidated balance sheet and respective fixed assets and in the consolidated profit and loss Account.

7) The minority interest in the profit of subsidiary company should be transferred minority interest account, in the proportion of total profit after adjustment of revaluation of fixed assets, but before adjusting unrealized profit on stock.

8) The share of holding company in pre-acquisition profit should be transferred to cost of control, in case shares are acquired during the year.

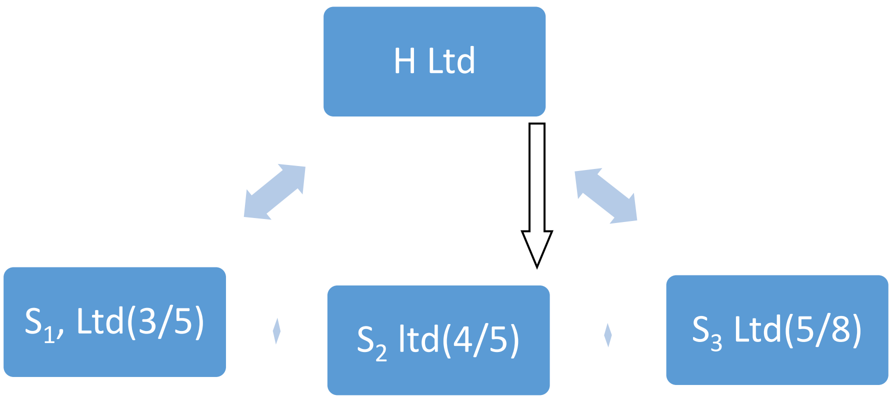
9) Share of holding company in the past acquisition profits shall be considered as revenue profits.

10) The balance in holding company columns will represents the total profit or loss made or suffered by the group as a whole.

4.10 Group Consisting of More than one Subsidiary

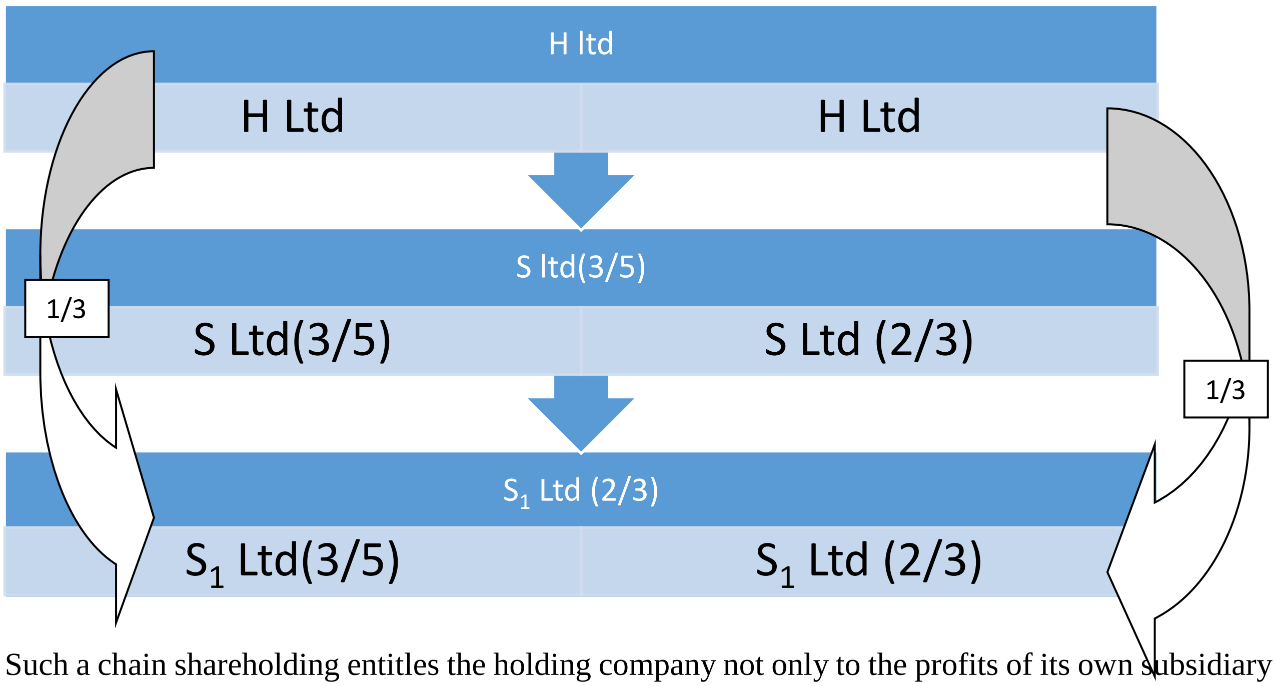
There can be three situations:

a) Holding company may have a number of subsidiaries without any short of mutual holding in between the subsidiaries as shown in the following chart:



In such a case, there will be no particular difficulty in preparing the consolidated balance sheet. The computation of cost of control, minority interest for each company, will be done on the principles already explained in earlier pages. Elimination of mutual indebtedness, unrealised profits on closing stock etc. should also be done in normal way.

b) Chain Holding: The holding company may hold shares in a subsidiary company and the subsidiary company, with or without the holding company, may hold shares in a subsidiary company. The different types of chain shareholding can be understand by the following figure:



Such a chain shareholding entitles the holding company not only to the profits of its own subsidiary but also to the profits of subsidiary company not only to the profits of its own subsidiary but also to the profits of sub-subsidiary company which it may control through its own subsidiary. Such profit which a holding is entitled on account of its investment in subsidiary company is termed as "Dividend Profits". The rules regarding dividend profit are as follows:

1. The profits of subsidiary company are first analysed the difference between pre-acquisition and post- acquisition profits. The share of minority in the pre-acquisition profits and post-acquisition profit is added to the minority interest. The share of subsidiary company in the capital profit of subsidiary company is directly transferred to the cost of control and is not normally routed through subsidiary company.

2. Particular care has to be taken in those cases where the subsidiary company owns a sub-subsidiary before acquisition of controlling interest by the holding company in the subsidiary

company. In such case any profit earned by the subsidiary company after acquiring controlling interest in subsidiary company, is a revenue profit from the point of view of holding company because it may not have acquired controlling interest in the subsidiary company's profits in such a case will have to be further analysed between capital and revenue from the point of holding company.

c) There may be cross holding: Subsidiary company may have shares in the holding company as well of course, according to the Companies Act, a subsidiary company cannot acquire shares in its holding company after becoming subsidiary but it can continue to hold those shares in the holding company which it acquired before it became its subsidiary. In such a case, the minority interest and share of holding company in capital reserve or in capital profits or revenue profits can be found out by means of simultaneous equations. It should be noted that in case of cross holdings, it is the date on which the holding company acquired controlling interest in the subsidiary company is to be taken into account for segregating the profits between capital and revenue, since the profits of the subsidiary up to the date, the holding company acquired control over it through revenue in nature, are capital from point of view of holding company.

Example 8: The following are summarized balance sheets of 'X' Ltd. and 'Y' Ltd. as on 31st December 2010

BALANCE SHEETS OF 'X' LTD. AND 'Y' LTD.
as on 31st December

Liabilities	***Rs. X Ltd.***	***Y Ltd.***	***Assets***	***Rs. X Ltd.***	***Y Ltd.***
Equity Shares@ Rs. 100	10,00,000	300,000	Freehold Property	4,50,000	1,20,000
General Reserve	400,000	1,25,000	Plant & Machinery	3,50,000	1,60,000
Profit & Loss A/c	3,00,000	1,75,000	Furniture	80,000	30,000
Sundry Creditor	1,00,000	70,000	Debtors	300,000	1,70,000

			Stock	3,20,000	1,60,000
			Shares in Y Ltd.	2,60,000	
			Cash	40,000	30,000
Total	**18,00,000**	**6,70,000**	**Total**	**18,00,000**	**6,70,000**

You are required to prepare a consolidated balance sheet as on 31st December 2010. Showing in detail of necessary adjustments and taking into consideration the following information

a) 'X' Ltd. acquired the shares of Y Ltd. on 1.1.2010 when the balance on their P and L account and general reserve were Rs. 75000 and Rs. 80000 respectively.

b) Stock of Rs. 1,60,000 held by 'Y' Ltd. consists of Rs. 60,000 goods purchased from 'X' Ltd. Who has charges profit at 25% on cost?

c) Included in Debtors of X Ltd. Rs. 30000 due from Y Ltd.

CONSOLIDATED BALANCE SHEET OF X LTD. AND Y. LTD.
As on 31.12.2010

Liabilities	***Rs. X & Y Ltd***	***Assets***	***Rs. X & Y Ltd***
Equity Shares@ Rs. 100	10,00,000	Freehold Properties	5,70,000
Capital Reserve	43,333	Plant & Machinery	5,10,000
General Reserve	4,30,000		
Profit & Loss A/c	35,867	Furniture	1,10,000
Sundry Creditor	1,70,000	Debtors	4,70,000
Minority Interest	200,000	Stock	4,68,000
		Cash	70,000
Total	**21,98,000**	**Total**	**21,98,000**

Working Notes

1) Calculation of capital reserve

Investment cost		2, 60,000
Less: i) Share in Share capital	2, 00,000	
Less: ii) Propionate Pre-acquisition profit	1, 03,333	3, 03,333

	--------------	----------------
	Capital Reserve	43,333
		==========

2) Minority Interest

Share in Share Capital	1, 00,000
⅓ rd of General Reserve	41,667
⅓ rd of Profit & Loss A/c	58,333

	2, 00,000
	=========

3) General Reserve:

Of X Ltd		4, 00,000
Of Y Ltd (125000- Pre-acquisition 8000)	45,000	
Less: Due to minority shareholders (⅓)	15,000	30,000

		4, 30,000
		========

4) Unrealised profit

Unrealized profit = 20% of 60,000	12,000

5) Profit & Loss Account

X Ltd. (300000-unrealised profit)		2, 88,000
Y Ltd. (175000-Pre-acquisition 75000)	1, 00,000	
Less: ⅓ rd of minority	33,333	66,667

		3, 54,667
		=======

Example-9 Big Ltd. holds all the shares of Medium Ltd. Medium Ltd. holds all the shares in Small Ltd. and would be known as medium division and small division. Their balance sheet on 30th June 2011, are given below:

Particulars	*Big Ltd.*	*Medium Ltd.*	*Small Ltd.*
Liabilities and Capital			
Equity shares @ 10	1,00,00,000	50,00,000	25,00,000
Reserve	80,00,000	20,00,000	15,00,000
Profit and Loss A/c	20,00,000	10,00,000	10,00,000
Unsecured Loans	1,00,00,000	20,00,000	30,00,000
Current Liabilities	60,00,000	20,00,000	20,00,000
Total	**3,60,00,000**	**1,20,00,000**	**1,00,00,000**
Assets			
Fixed Assets	75,00,000	30,00,000	20,00,000
Investment in Medium Ltd.	70,00,000		
Investment in Small Ltd.		30,00,000	
Investment in Giant Ltd.	70,00,000	50,00,000	30,00,000
Current Assets, Loan & Advances	1,45,00,000	10,00,000	50,00,000
Total	**3,60,00,000**	**1,20,00,000**	**1,00,00,000**

The share capital of Giant Ltd. on 30 June 2011 is Rs 1, 50, 00,000 divided into 15, 00,000 equity shares of Rs 10 each. Of these 5,00,000 shares are held by Big Ltd., 4,00,000 shares by medium Ltd and 3,00,000 shares by small ltd. The balance sheet of Giant Ltd as at 30 June 2011 is as follows:

BALANCE SHEET OF GIANT LTD

Liabilities	*Rs*	*Assets*	*Rs.*
Shares Capital	1,50,000	Fixed Assets	2,00,00,000
Reserve	1,00,00,000	Investment	50,00,000

Profit and Loss A/c	50,00,000	Current Assets, loan and Advances	3,50,00,000
Secured Loan	1,00,00,000		
Other liabilities	2,00,00,000		
Total	**6,00,00,000**	**Total**	**6,00,00,000**

Show journal entries in the books of Big Ltd and the consolidated Balance Sheet with its subsidiary Giant Ltd. as on 1 July, 2011.

Solution

Big Ltd
Journal Entries

Date	***Particulars***	***Dr***	***Cr***
30 June,2011	Fixed Assets A/c Dr	30,00,00,000	
	Investment in Small Ltd. A/c Dr	30,00,00,000	
	Investment in Giant Ltd. A/c Dr	50,00,00,000	
	Current Assets, Loans and Advances A/c Dr	10,00,00,000	
	To Unsecured Loans A/c		20,00,00,000
	To Current Liabilities A/c		20,00,00,000
	To Investment in Medium Ltd. A/c		70,00,00,000
	To Capital Reserve A/c		10,00,00,000
	Being taken over of assets and liabilities of Medium Ltd.		
	Fixed Assets A/c Dr	20,00,00,000	
	Investment in Giant Ltd A/c Dr	30,00,00,000	
	Current Assets, Loan And Advances A/c Dr	50,00,00,000	
	To Unsecured Loan A/c		30,00,00,000
	To Current Liabilities A/c		20,00,00,000
	To Investment in Small Ltd A/c		30,00,00,000
	To Capital Reserve A/c		20,00,00,000
	Being assets and liabilities of Small Ltd. taken over		

Big Ltd. and its Subsidiary Giant Ltd.
Consolidated Balance Sheet

Liabilities and Capital	***Rs.***	***Assets***	***Rs.***
Equity Capital @ Rs 10	1,00,00,000	Fixed Assets:	
		Big Ltd.	1,25,00,000
		Giant Ltd.	

			2,00,00,000
Capital Reserve	80,00,000	Investments	50,00,000
General Reserve	80,00,000	**Current Loan & Advances**:	
		Big Ltd.	2,05,00,000
		Giant Ltd.	3,50,00,000
Profit and Loss A/c			
Big Ltd.	20,00,000		
Giant Ltd.	40,00,000		
Unsecured Loan	1,50,00,000		
Current Liabilities & Provisions			
Big Ltd.	1,00,00,000		
Giant Ltd.	2,00,00,000		
Minority Interest	60,00,000		
Total	**9,30,00,000**	**Total**	**9,30,00,000**

Working Notes

1. **Cost of Control**

		Rs.
Cost of shares in Giant Ltd.		1, 50, 00,000
Paid up value		1, 20, 00,000
Share of capital Profit	80, 00,000	2, 00, 00,000
Capital Reserve		50, 00,000
Add: Capital Reserve From Medium Ltd. And Small Ltd		30, 00,000

2. It is assumed that the reserve of Giant Ltd is out of pre-acquisition profits and the balance in the profit and loss wholly a post-acquisition profit.

3. **Minority Interest in Giant Ltd**

1/5 share of share capital	30, 00,000
Reserve	20, 00,000
Profit and Loss A/c	10, 00,000
	60, 00,000

4.11 Summary

A holding company is one which directly or indirectly acquires either all or more than half the number of equity shares in one or more companies so as to secure a controlling interest in such companies, which are then recognized as subsidiary companies. AS-21 comes into effect in respect of accounting periods commencing on or after 1st April 2001 i.e. for year ending March 31st 2002. The AS 21 is applicable to all the enterprises that prepare consolidated financial statement. It is compulsory for listed companies and banking companies. As per AS 21, The consolidated financial statements would include: i) Profit & Loss A/c ii) Balance sheet iii) Cash flow statement iv) Notes of Accounts except typical notes. v) Segment reporting. AS 21 also desire various import terms, as well as dealing the same while preparing consolidated financial statement. Consolidated financial statements should be prepared for both domestic as well as foreign subsidiaries. The following points need special attention while preparing consolidated balance sheet. are a) Share of parent company and share of minority (outside shareholders). b) Date of Balance sheet of holding company and that of various subsidiary companies must be same. If they are not so required adjustment must be made before consolidation. c) Date of Acquisition of control in subsidiary companies. d) Inter-company owing and e) Revaluation of fixed assets as on date of acquisition, depreciation, adjustment of revaluation amount etc.

4.12 Keywords

Minority Interest: Interest of shareholder in partly owned subsidiary company other than the holding company.

Holding Company: A company which control other company either by acquisition or by power to appoint majority of directors of the company.

Partly Owned Subsidiary: The Company in which the holding company does not owned all shares.

Wholly owned subsidiary: The Company in which the holding company acquired all shares.

4.13 Review Questions

1. Define the term holding company. Explain the consolidation process with hypothetical example.
2. What are the advantage of consolidation of statements of holding and subsidiary companies?
3. Define the term minority interest. Explain the process to calculate with suitable example.
4. ABC Ltd. acquired 8,000 equity shares of Canning Company Ltd. on 1st January 2012. The

following are the balance sheet of two companies as on 31st December, 2011.

BALANCE SHEET

Liabilities	**ABC Ltd.**	**Canning Ltd.**	***Assets***	**ABC Ltd.**	**Canning Ltd.**
Equity Shares @100	20,00,000	10,00,000	Land & Buildings	5,00,000	3,00,000
General Res.	4,00,000	2,00,000	Plant & Machinery	5,00,000	6,00,000
Profit and Loss A/c 1 Jan 2012	1,00,000	60,000	Stock	1,50,000	1,00,000
Sundry Creditors	1,00,000	1,00,000	Sundry Debtors	1,00,000	1,20,000
Profit for 2011	2,00,000	80,000	Investments: Shares of Canning Ltd.	10,00,000	
Bills Payable	30,000	10,000	Bills Receivable	80,000	10,000
			Cash and Bank	5,00,000	3,20,000
Total	**28,30,000**	**14,50,000**	**Total**	**28,30,000**	**14,50,000**

1. Bills receivable of ABC Ltd. includes Rs. 10,000 accepted by Canning & Co Ltd.
2. Sundry debtors of ABC Ltd., include Rs. 50,000 due from Canning & Co. Ltd.
3. Stocks were invoiced by ABC Ltd., at a profit of 25 per cent on cost.

Prepare a consolidated balance sheet of ABC Ltd. and subsidiary Canning & Co. Ltd.

5. Balance Sheet of H Ltd. as on 31st December, 2012 was as follows:

Liabilities	**H Ltd.**	**S Ltd.**	***Assets***	**H Ltd**	**S Ltd.**

Equity Shares @1	10,000	6,000	Assets	16,000	10,000
General Reserve	4,000		4,000 Shares in S Ltd.	4,000	
Creditors	2,000	2,200			
Profits	4,000	1,800			
Total	**20,000**	**10,000**	**Total**	**20,000**	**10,000**

Shares were purchased by H Ltd. in S Ltd. on 30th June, 2012. On 1st January, 2012, the balance sheet of S Ltd showed loss of Rs. 3,000 which was written off out of the profits earned during 2012. Profits are assumed to accrue evenly throughout the year. Prepare consolidated balance sheet.

4.14 Further Readings

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.
2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.
5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

Chapter-5

ACCOUNTING FOR BANKING COMPANIES

5.0 Objectives

After the study of present chapter the student will be able to**:**

1. understand various provisions relating to final accounts of Banking companies;

2. get familiar with prescribed format of financial statement of Banks;

3. get overview of RBI guidelines for accounting of Banking companies and

4. explain the meaning of certain key terms of Banking.

5.1 Introduction

A bank is a commercial institution, permitted to accept, collect, transfer, lend and exchange money and claims to money**,** both domestically and internationally and thereby conduct smooth banking activities.

5.2 Definition

Banking companies are governed by the Banking Regulation Act of 1949 and also subject to the Companies Act 1956.

According to Banking Regulation Act, 1949 Banking means –

"The accepting, for the purpose of lending or investment, of deposit of money from the public**,** repayable on demand or otherwise and withdraw able by cheque, draft, order or otherwise."

5.2.1 Business of Banking Companies

As per Section 6 of Banking Companies (Regulation) Act, 1949, banking companies may engage in the following business in addition to their usual banking business.

1. The borrowing, raising or taking up on money, the lending or advancing of money either upon or without security, the drawing, making, accepting, discounting, buying, selling, collecting and dealing in bills of exchange, 'hundies', promissory notes, drafts, bills of landing, railways receipt, warrants, debentures, certificates, scrips and other instruments and securities whether transferable or negotiable or not; granting and issuing of letters of credit, traveller's cheques and circular notes; the buying and selling of foreign exchange including foreign bank notes; the acquiring, holding, issuing on commission, underwriting and dealing in stock, funds, shares, debentures, debenture stock bonds, obligations, securities and investments of all kinds; the purchasing and selling of bonds, scrips or other forms of securities on behalf of constituents or other, the negotiating of loans and advances; the receiving of all kinds of bonds, scrip or valuables on deposit or for safe custody or otherwise; the providing of safe deposit vaults; the collecting and transmitting of money and securities.

2. Acting as agents for any Government or local authority or any other person or persons, carrying on a agency business of any description including the clearing and forwarding of goods, giving of receipts and discharges and otherwise, acting as an attorney on behalf of customers but excluding the business of (managing agent or secretary and treasurer) of a company.

3. Contracting for public and private loans and negotiating and issuing the same.

4. The effecting, insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private of state, municipal or other loans or of shares, stock, debentures or debenture stock of any Company**,** Corporation or Association and of the lending of money for the purpose of any such issue.

5. Carrying on and transacting every kind of guarantee and indemnity business.

6. Managing, selling and realizing any property which may come into the possession of the company in satisfaction or part satisfaction of any of its claims.

7. Acquiring and holding, generally dealing with any property or any right, title or interest in any such property which may form the security or part of the security for any loans or advances which may be connected with any such security.

8. Undertaking and executing trusts.

9. Undertaking the administration of estates as executor, trustee or otherwise.

10. Establishing and supporting or aiding in the establishment and support of associations, institutions, funds, trusts and conveniences**,** calculated to benefit employees or ex-employees of the company or the dependents or connections of such persons; granting pensions and allowances and making payments towards insurance; subscribing to or guaranteeing moneys for charitable or benevolent objects or for any exhibition or for any public, general or useful object.

11. The acquisition, construction maintenance and alteration of any building or works necessary or convenient for the purpose of the company.

12. Selling, improving, managing, developing, exchanging, leasing, mortgaging, disposing of or turning into account or otherwise dealing with all or any part of the property and rights of the company.

13. Acquiring and undertaking the whole or any part of the business of any person or company, when such business is of a nature enumerated or described in section 6.

14. Doing all such other things as are incidental or conclusion to the promotion or advancement of the business of the company.

15. Any other form of business which the central government may by notification in the Official Gazette, specify as a form of business in which it is lawful for a banking company to engage. No banking company shall engage in any form of business other than those referred to in section 6.

5.2.2 Restrictions on Business

The Banking Companies are restricted from conducting certain activities. A bank can not directly or indirectly deal in the buying or selling or bartering of goods, except in connection with the realization of security given to or held by it, or engage in any trade or buy or sell of barter goods for others**,** otherwise than in connection with bills of exchange, immovable property, except that required for its own use, however acquired, must be disposed of within seven years from the date of acquisition.

5.3 Books of Accounts

In order to have immediate entry of voluminous transaction and enable**s** continuous internal check on the record of these transactions, banks are required to maintain subsidiary books along with its principal books of accounts.

A) Subsidiary books

i. Receiving cashier’s counter cash book.

ii. Paying cashier’s counter cash book.

iii. Current accounts ledger.

iv. Savings bank accounts ledger.

v. Fixed deposit accounts ledger.

vi. Investments Ledger.

vii. Loans Ledger.

viii. Bills discounted and purchased ledger.

ix. Customer’s **acceptances, endorsements** and guarantee ledger.

B) Principal Books

i. Cash book: It records all cash transactions.

ii. General Leger : It contains control Accounts of all subsidiary ledgers and different assets and liabilities account.

5.4 Final Accounts

The Banking Regulation Act, 1949 prescribes formats of preparing final accounts of the Banking companies. The third schedule of section 29 gives forms ‘A’ for the balance sheet and Form ‘B’ for Profit and loss account. The balance sheet consists of total 12 schedules. Schedule 1 to schedule 5 depicts capital and liabilities and schedule 6 to schedule 11 shows assets of the bank and schedule 12 shows contingent liabilities and there is no specific schedule prescribed for bills for collection. Following are prescribed formats:

Form B
Profit and Loss Account
For the year ended 31st March...

S. No	Particulars	Schedule	As on 31.3 (Current Year)	As on 31.3 (Previous Year)
1	**Income:**			
	Interest Earned	13		
	Other Income	14		
	Total			
2	**Expenditure:**	15		
	Interest expanded	16		
	Total			
3	**Profit/Loss**			
	Net Profit for the year			
	Profit brought forward			
4	Appropriations			
	Transfer to statutory reserve			
	Transfer to General reserve			
	Proposed dividend			
	Balance carried forward to balance sheet			

Format of Balance Sheet

The Third Schedule (Section 29)

Balance Sheet as on 31st March ----

S. No	**Particulars**	**Schedule**	**As on 31.3 (Current Year)**	**As on 31.3 (Previous Year)**
1	**Capital and Liabilities:**			
	Capital	1		
	Reserve and surplus	2		
	Deposit	3		
	Borrowings	4		
	Other liabilities and provisions	5		
	Total			
2	**Assets:**			
	Cash in hand and balance with RBI	6		
	Balances with other banks	7		
	Investments	8		
	Advances	9		
	Fixed Assets	10		
	Other Assets	11		
	Total			
3	**Contingent Liabilities:**			
	Bills for Collection	12		

Process of preparation of final accounts for banking companies can be better understood with help of example given below:

Example: 1 The following is the trial Balance of Vijay bank Ltd as on 31st March, 2012.

Particulars	Amount	Particulars	Amount
Cash in hand and RBI	75,000	Share capital	3,00,000
Investment in Govt of India Bond	1,94,370	Security Deposit of employees	15,000
Other investment	1,55,630	Saving bank Account	7,420
Gold	15,130	Current account	97,000
Interest accrued on investments	24,620	Fixed Deposit	23,050
Silver	2,000	Securities premium	90,000
Building	65,000	Statutory reserve	1,40,000
Furniture	5,000	Borrowings from banks	77,230
Money at call and short notice	26,000	P & L A/c Balance	6,500
Advances	2,00,000	Bills for collection	43,500
Bills receivable being bills for collection	43,500	Interest	72,000
Bills discounted and purchased	12,500	Commission & Brokerage	25,300
Interest paid	7,950	Discount on bill discounted	42,000
Auditor fees	5,000	Rent	600
Loss on sale of furniture	1,000	Profit on Bullion	1,200
Director fees	1,200	Misc. Income	2,700
Salaries	21,200		
Postage	50		
Managing director's remuneration	12,000		
Loss on sale of Investment	30,000		
Deposit with other banks	35,000		
Branch adjustment	11,350		
	9,43,500		**9,43,500**

You are required to prepare a Profit and Loss A/c and balance sheet on 31st March 2012 by taking into account the following:

1. Provide for rebate on bills discounted Rs 4,500
2. Charge depreciation @ 5 % on building and 20% on furniture.
3. A provision for doubtful debts to the extent of Rs 12,500 is required.
4. Claims for bonus by employees are Rs 5000 is pending for award of arbitration.
5. Transfer 25% of the current year's profit to the statutory reserve.
6. Directors declared the dividend of 12%.

7. A scrutiny of account ledger reveals that there are accounts overdrawn to the extent of Rs 42,000 and the credit balance is Rs 1, 39,000.

Solutions

Balance sheet
As on 31st March, 2012

S.No	Particulars	Schedule	As on 31.3.2012 (Rs)
1	Capital and Liabilities		
	Capital	1	3,00,000
	Reserve and surplus	2	2,44,650
	Deposit	3	1,69,470
	Borrowings	4	77,230
	Other liabilities and provisions	5	55,500
	Total		**8,46,850**
2	**Assets**		
	Cash in hand with RBI	6	75,000
	Balance with other banks	7	61,000
	Investment	8	3,65,130
	Advances	9	2,42,000
	Fixed Assets	10	65,750
	Other assets	11	37,970
	Total		**8,46,850**
3	Contingent liabilities	12	5000
	Bills for collection	12	43,500

Profit and Loss Account
For the year ending on 31st March, 2012

S.No	**Particulars**	**Schedule**	**Amount (Rs)**
1	**Income**		
	Interest Earned	13	1,09,500
	Other Income	14	(1,200)
	Total		**1,08,300**
2	**Expenditure**		
	Interest Expended	15	7,950
	Operating Expenses	16	43,700
	Provisions and contingencies		12,500
	Total		**64,150**
3	**Profit /Loss**		
	Net Profit for the year		44,150
	Profit brought forward		6,500
	Total		**50,650**
4	**Appropriations**		
	Transfer to statutory Reserve		11,038
	Proposed dividend		36,000
	Balance carried forward to balance sheet		3,612

	Total	**50,650**

SCHEDULE-1 Capital

S.No	Particulars	Amount
1	Capital	300,000

SCHEDULE-2 Reserve

S.No	Particulars	Amount
1	Statutory Reserve 1,40,000 + Addition 11,038	1,51,038
	Securities premium	90,000
	Balance of Profit and Loss A/c	3,612

SCHEDULE-3 Deposits

S.No	Particulars	Amount
1	Current Account	1,39,000
2	Saving Bank account	7,420
3	Fixed Deposit account	23,050
		1,69,470

SCHEDULE-4 Borrowings

S.No	Particulars	Amount
1	Borrowings	77,230

SCHEDULE-5 Other liabilities

S.No	Particulars	Amount
1	Rebate on bill	4,500
2	Security Deposit	15,000
3	Proposed Dividend	36,000
	Total	**55,500**

SCHEDULE-6 Cash in Hand with RBI

S.No	Particulars	Amount
1	Cash in hand with RBI	46,350

SCHEDULE-7 Cash with other Banks and Money at Call and Short Notice

S.No	Particulars	Amount
1	Cash with other Banks	75,000
2	Money at call and short Notice	26,000
	Total	**1,01,000**

SCHEDULE-8 Investment

S.No	Particulars	Amount
1	Government investment	75,000
2	Money at call and short Notice	26,000
	Total	**1,01,000**

5.5 Guidelines of RBI for Compilation of Financial Statements Balance Sheet

Item	Schedule	Coverage	Notes & Instructions
Capital	1	Nationalized Banks Capital (fully owned by Central Government)	The capital owned by Central Government as on the date of the Balance Sheet, including contribution from

			Government, if any, for participating in World Bank, Projects, should be shown.
		Banking Companies Incorporated outside India	(i) The amount brought in by banks by way of start up capital as prescribed by RBI, should be shown under this head. (ii) The amount or deposits kept with RBI under sub-section 2 of Section 11 of the Banking Regulation Act, 949 should also be shown.
		Other Banks (Indian) Authorized Capital (… shares of Rs… each) Issued Capital (… Shares of Rs... Each) Subscribed Capital (… Shares of Rs…. Each) Called-up Capital (… Shares of Rs… each) Less: Calls unpaid Add: Forfeited shares: Paid up Capital	Authorized, Issued, Subscribed, Called-up Capital should be given separately. Calls-in arrears will be deducted from Called-up Capital while the paid-up value of forfeited shares should be added, thus arriving at the paid-up capital. The necessary items which can be combined should be shown under one Head, for instance, "Issued and Subscribed Capital". Notes: General The changes in the above items, if any, during the years, say, fresh contribution made by the Government, fresh issue of capital, capitalization of reserves, etc., may be explained in the notes.
Reserves And Surplus	2	(I) Statutory Reserves	Reserves created in terms of Section 17 or another section of Banking Regulation Act must be separately disclosed.
		(II) Capital Reserves	The expression 'capital reserve' shall not include any amount regarded as free for distribution through the Profit and Loss Account. Surplus on revaluation should be treated as Capital Reserves. Surplus on translation of the financial statements of foreign branches (which includes fixed assets also) is not a revaluation reserve
		(III) Share Premium	Premium on issue of share capital may be shown separately under this head.
		(IV) Revenue and other Reserves	The expression 'Revenue Reserve' shall mean any reserve other than those separately classified. This expression 'reserve' shall not include any amount, written-off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability

	(V) Balance of Profit	Includes balance of profit after appropriation. In case of loss the balance may be shown as a deduction. Notes: General Movement in various categories of reserves should be shown as indicated in the schedule.
Deposits	A.(I)Demand Deposits (i) from banks (ii) from others	Includes all bank deposits repayable on demand. Include all demand deposits of the nonbanking sectors. Credit balances in overdrafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, certificate of deposits, etc. are to be included under this category.
	(ii)Saving Bank Deposits	Includes all savings bank deposits (including inoperative savings bank accounts).
	(III) Term Deposits (i) from banks (ii) from others	Includes all types of bank deposits repayable after specified term. Includes all types of deposits of the nonbanking sector, repayable after a specified term. Fixed deposits, cumulative and recurring deposits, annuity deposits, deposits mobilized under various schemes, ordinary staff deposits, foreign currency non-resident deposit accounts, etc., are to be included under this category.
	(i) Deposits of branches in India (ii) Deposits of branches outside India	The total of these two items will agree with the total deposits. Notes : General (a) Interest payable on deposits which is accrued but not due should not be included but shown under other liabilities. b) Matured time deposits and cash certificates, etc., should be treated as demand deposits. c) Deposits under special schemes should be included under the term deposits, if they are not payable on demand. When such deposits have matured for payment they should be shown under demand deposits. d) Deposits from banks will include deposits from the banking system in India,

			co-operative banks, foreign banks, which may or may not have presence in India.
Borrowings	4	Borrowings in India (i) Reserve Bank of India (II) Other Banks (iii) Other institutions and agencies.	Includes borrowing / refinance obtained from Reserve Bank of India Includes borrowings / refinance obtained from commercial banks (including co-operative banks). Includes borrowings / refinance obtained from industrial Development Bank of India, Export-Import of 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 Secured Borrowings included above	Includes borrowings of Indian 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. Note: General (i) The total of I and II will agree with the total borrowings shown in the Balance Sheet. (ii) Inter-office transactions should not be shown as borrowings. (iii) Funds raised by foreign branches by way of certificate of deposits, notes, bonds, etc., should be classified depending upon documentation, as ‘deposits’, ‘ borrowings’, etc. (iv) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head ‘Borrowings’. Hence, advances will be shown at the gross amount on the assets side.
Interest Expended	15	I. Interest on Deposits	Includes interest paid on all types of deposits including deposits from banks and other institutions.
		II. Interest on Reserve Bank of India / interbank borrowings	Includes discount / interest on all borrowings and refinance from the Reserve Bank of India and other banks.
		III. Others	Includes discount / interest on all borrowings / refinance from financial Institutions. All other payments like interest on participation certificates, penal

interest paid, etc. may also be included here.

5.6 Accounting Policies

In order that the financial position of banks represent a true and fair view, the Reserve Bank of India has directed the banks to disclose the accounting policies regarding the key areas of operations along with the notes of account in their financial statements for the accounting year ending 31.3.1991 and onwards, on a regular basis. The accounting policies disclosed may contain the following aspects subject to modification by individual banks:

1) General

The accompanying financial statements have been prepared on the historical cost 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 rates, 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 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 losses on pending forward contracts have been accounted for.

3) Investments

a) Investments in Governments and other approved securities in India are valued at the lower of cost or market value.

b) Investments in subsidiary companies and associate companies (i.e., companies in which the bank holds at least 25 percent 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 identified advances, based on a periodic 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 the guidelines issued by the Government of India and the Reserve Bank of India.

b) Provisions in respect of doubtful advances have been deducted from the advances to the extent necessary and the excess have 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 the value determined on the basis of such revaluation made by the professional values; profit arising on revaluation 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 figures and an amount equal to the additional depreciation consequent of 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 have been made on an accrual / casual 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 the statutory requirements.

ii) Provisions for doubtful advances.

iii) Adjustments to the value of "current investments" in Government and other approved securities in India, valued at lower of cost or market value.

iv) Transfers to contingency funds.

v) Other usual or necessary provisions.

b) Contingency funds have been grouped in the balance sheet under the head "Other liabilities and provisions".

5.7 Income Recognition

Assets of the banks are classified as per performing assets and non-performing assets for purpose of income recognition. Assets which are not non-performing are performing assets. An asset becomes non-performing when it ceases to generate income for banks. Non- performing assets would be an advance where:

i. . Interest and instalment of principal remain overdue for a period of more than 90 days in respect of term loan,
ii. . The account remains 'out of order' for a period of more than 90 days in respect of overdraft and cash credit.
iii. . The bill remains overdue for a period of more than 90 days in case of bill purchased and discounted,
iv. . Interest and or instalment of principal remains overdue for two harvest seasons but for period on not exceeding two half years in case of advance granted for agriculture purpose.

v. Any amount to be received remains overdue for a period of not exceeding 90 days in respect any other accounts.

Example-2 Given below are details of interest on advances of commercial banks as on 31-03-2012.

	Interest Earned Rs. in Lakhs	**Interest Received Rs.in Lakh**
Performing Assets		
Term Loan	240	160
Cash Credit and Overdraft	1,500	1,240
Bills Purchased & Discounted	300	300
Non- performing Assets		
Term Loan	150	10
Cash Credit and Overdraft	300	24
Bills Purchased & Discounted	200	40

Find out the income to be recognised for the year end 31-03-2012.

Solution

Interest on performing assets should be recognised on accrual basis but interest on non-performing assets should be recognised on Cash basis as per directions given in various circulars issued by R.B.I

Interest on term loan (240 + 10)	250
Interest on cash and bank overdraft (1500+ 24)	1524
Income from bill purchased and discounted (300 + 40)	340
Income to be recognised	**2114**

Assets Classification and Provisions for Doubtful Debts

Banks are required to classify the loans into four categories:

1. **Standard Assets:** Assets which does not disclose any problem in payment of interest and principal.
2. **Sub Standard Assets:** The assets which have been classified as non-performing for a period not exceeding 18 months.
3. **Doubtful Assets:** Assets which have remained in substandard category for more than 18 months.
4. **Loss Assets:** A loss asset is one where loss has been identified by the bank, although there may be some recovery value/salvage value.

   Provisions: The purpose of classification of bank assets is to make adequate provisions on the basis of quality of assets, the realisation of the security and erosion in the value of security. Banks should make provisions against various assets on the following basis:

   a) **Standard Assets:** 0.25%

   b) **Sub Standard** Asset: 10 % of total **out-standing**

   c) **Doubtful Assets:** To the extent debt not covered by **security 100%provisiuon shall be maintained.** In addition to the above, on secured portion provision between 20 to 50 % depending upon period as given below:

Upto one year	20 %
More than one year but **upto** 3 years	30 %
Above three Years	50 %

   d) **Loss Assets:** 100 %

Example-3 Compute the amount of provisions for doubtful debts from the following details of advances of National Bank Ltd. **As on**

		Rs in Lakhs
1.	Total Loans and advances	50

2. Fully secured advances without any default 30

3. Advances overdue for 15 months 10

4. Advance overdue for more **?** 15 months but less than 36 months 5

(Secured by mortgage of plant worth Rs 3 lakhs)

5. Non-recoverable unsecured advances 3

6. Small advances not exceeding Rs 25,000 **to each** 2

Solution

Computation of Provision for Doubtful Debts

S. No.	**Category**	**Rs Lakhs**	**Provisions for Doubtful Debt**	
			%	**Rs.**
1.	Standard Assets	30	0.25	75,000
2.	Sub Standard Assets	10	10	1,00,000
3.	Doubtful Assets	5	Unsecured portion + 30 % of secured Portion	2,90,000
4	Loss Assets	3	100	3,00,000
5	Small Advances	2	15	30,000
		50		**7,95,000**

5.8 Provisions for Taxation

Its treatment till a few years back was on the pattern of bad and doubtful debts. The amount of provision for taxation was quietly deducted from interest and discount income. In the balance sheet, the amount was merged with current and contingent account on the liabilities side. However with effect from 1.4.1991, the above practice has undergone a change. In the new format the item has to be shown as follows:

The Amount of provision for taxation has to be charged to the profit and loss account under the heading ‘provisions and contingences’. In the balance sheet it will be shown in head ‘other liabilities and provisions’ on the liabilities side.

i.8 **Classification of Bank Advances**

As per the RBI guidelines a Banking company can classify its advances in the following categories:

1. Bill Discounted and Purchased
2. Cash Credit, Overdrafts and Loans Repayable on Demand
3. Term Loans
4. Secured by Tangible Assets
5. Covered by Banks and Government Guarantee
6. Unsecured
7. Advances in India: Private Sector and Public Sector

i.9 **Classification of Investment**

According to revised guidelines of RBI w.e.f 30 September, 2000, the banks are required to classify their entire portfolio investment into following three categories:

a. Held to Maturity
b. Held for Trading
c. Available for sale

a. **Held to Maturity**

Held to maturity included all those securities which bank hold with intension to retain them up to maturity. These investments should not exceed 25% of bank’s total investments.

b. **Held for Trading**

This category covered all those assets which bank have purchased with **intention** to earn gain by short term price / interest rate fluctuations. These securities are sold within 90 days.

c. **Available for sale**

This category covered all those securities which are not covered by the head 'Held for Trading'.

Banks are free to decide the ration among securities Held for trading and available for sale.

Example-4 From the information given below relating to Dinesh Redhu Banking Ltd, prepare the Profit and Loss a/c the balance sheet as at the end of 31st March 2013, in the form prescribed in Banking Regulation Act 1949:

Particulars	Amount
Shares of Rs 100 each fully paid	2,00,000
Statutory reserve fund(fully investment in 5% Govt. Securities at par	1,20,000
Bad debts	12,875
Establishment expenses	1,27,725
Current Deposits	13,65,227
Interest paid	7,48,440
Saving A/c	17,20,000
Acceptance of customers	47,500
Discount	4,95,000
Profit & Loss a/c(credit)	8,20,400
Fixed Deposit	8,75,000
Commission	2,92,900
Premises	4,80,000
Cash in Hand	22,650
Interest Received	12,88,400
Investment in Shares	92,500
Cash With banks in India	2,84,500
Term loans in India	10,00,000
Cash Credit Hypothecation in India	12,56,000
Cash credit pledge in India	9,44,000
Bill Purchased	16,00,000
Loans to employees for Purchase of bicycles	40,770
Salaries, allowance, Bonus, PF	4,45,467
Dividend Paid for 2011-12	20,000
Dividend received on investment	8000

Additional Information:

1. The CEO of the Bank draws a remuneration of Rs. 40,000 p.a. Directors Fees and allowances are Rs. 8000. All these are included in salaries.
2. Unexpired discount as at 31st March 2013 was Rs. 8000.
3. Establishment Expenses include:

Advertisement	10,000
Stationary	63,000

Rent	18,000
Lighting	3,000
Audit Fees	8,000
Postage & Tel	4600
Revenue Stamp	400
Stamp paper	1500

4. An advance of Rs. 8000 included in cash credit hypothecation above is consolidated doubtful and needs to be fully provided.
5. Provide for taxation at 55 % plus surcharge at 5% thereon.
6. Make necessary appropriation for statutory reserve.

Solution

Dinesh Redhu Banking Co. Ltd
Profit and Loss A/c
For the year ending 31st March, 2013

	Schedule	Rs.
Income		
Interest earned	13	17,33,400
Other income	14	300,900
	Total	**20,34,300**
Expenditure		
Interest Expanded	15	7,48,440
Operating Expenses	16	5,73,192
Provisions & Contingencies(WN-1)		4,20,386
	Total	**17,24,018**
Profit: Net Profit for the year		2,92,282
Transferred to statutory Reserve		58,456
Taken to Balance sheet		2,33,826

Dinesh Reddu Banking Co. Ltd
Balance Sheet
As on 31st March, 2013

	Schedule	Rs.
Capital	1	2,00,000
Reserve and Surplus	2	12,12, 682
Deposits	3	39,60,227
Borrowings	4	----------

Other liabilities and Provisions	5	4,59,511
Total		**58,32,420**
Assets		
Cash and Balance with RBI	6	58,32,425
Balance with Banks & Money at call & short Notice	7	2,84,500
Investments	8	2,12,500
Advances	9	47,92,000
Fixed Assets	10	4,80,000
Other Assets	11	40,770
	Total	**58,32,420**
Contingent Liabilities	12	47,500

Working Note

Provisions and contingences:		
Bad Debt		12,875
Bad Debt Provisions		8,000
Provision for Tax		3, 99,511
Total		**4, 20,386**
Computation of Income Tax		
Interest earned		17, 33,400
Other income		300,900
Total		**20, 34,300**
Less: Interest Expanded		7, 48,440
Operating Expenses		6, 73,192
Provisions for bad debts	20,875	13, 42,507
Profit before tax		**6,91,793**
Tax @ 55%		3, 80,487
Surcharge @ 5%	19024	3, 99,511
Net profit after tax		**2, 92,282**

5.11 Summary

A bank is a commercial institution, which accepts deposits and repay on **demand,** transfer and invest the money. Banking companies are governed by Banking Regulation Act, 1949 and also subject to the companies Act, 1956. The various accounting provisions regarding minimum capital and reserves; restriction on commission, brokerage, discount on sale of shares, restrictions on payment of dividend, statutory reserves, cash reserves and restrictions on loans and advances given under various sections of Banking Regulation Act, 1949. The banks keep subsidiary and principal books of accounts to minimize the errors in maintaining records of voluminous transactions. The final accounts of banking companies are prepared as per the formats given under form 'A' for balance sheet and form 'B' for profit and loss account. Out of 16 schedules, form A contains 12 schedules and form B contains the remaining 4 schedules.

5.12 Key Words

1. Inter office: It represents the difference on account of incomplete recording of transactions between one branch and another branch or between the branch and head office.

2**.** Non- Performing **Assets**: An asset which ceases to generate income for the banks.

3. **Statutory Reserve**: A reserve created by bank as per section 17 of Banking Regulation Act 1949.

5.13 Review Questions:

1. Explain various legal provisions relating the final accounts of a Banking company.

2. Right a short note **on:**

    a. Provision for taxation

    b. Income recognition

3. Explain the guidelines issued by RBI for accounting practices in banking companies.

4. As on 31st December 1995, the books of the Vikram Bank, include among others the following balances:

Rebate bills discounted (1-1-1995)	3, 20,000
Discount received	46, 00,000
Bills discounted and purchased	3, 15, 47,000
Bills for collection	12, 00,000

Throughout 1995**,** the bank's rate for discounting has been 18% and rate of commission on bills for collection, 4 %.

On investigation and analysis, the average due date for the bills discounted and purchased in calculation 15th February, 1996 and that for bills for collection as 15th January 1996.

Show the calculation of the amount to be credited to the bank's profit and loss A/c under discount earned for the year 1995. Show also the journal entries required to adjust the above mentioned accounts.

5. From the flowing information prepare the profit and loss a/c of ABC Bank Ltd. for the year ended on 31st March 1997 in the prescribed from:

Interest on Loan	2, 59,000
Interest on Fixed Deposit	2, 75,000
Rebate on bills discounted required	49,000
Commission	8,200
Established	54,000
Discount on bills discounted (net)	1, 95,000
Interest of Cash Credit	2, 23,000
Interest on Current Account	42,000
Rent and Taxes	18,000
Interest on Overdraft	1,54,000

Director's Fees	3,000
Auditors Fees	1,200
Interest on Saving Bank Deposit	68,000
Postage and Telegrams	1,400
Printing and Stationary	2,900
Sundry Charges	1,700

Bad debts to be written off, Rs 40,000. Provisions for taxation may be made @ 55%. Balance of profit and loss from last year was Rs 1, 20,000. The Directors have recommended a dividend of Rs 20,000 for the shareholders.

5.13 Further Reading

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.
2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
3. Gupta R.L. & Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.
5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

CHAPTER-6

ACCOUNTING FOR INSURANCE COMPANIES

Dr. Sushil Kumar

6.0 Objectives

After the study of the present chapter the students will be able to:

1. **D**efine the term insurance;
2. understand accounting treatment of insurance companies and
3. explain the meaning of certain key terms.

6.1 Introduction

The business of Insurance in India is governed by The Insurance Act, 1938 along with the regulations framed by Insurance Regulations and Development Authorities Act, 1999 (IRDA)**.** Insurance is an agreement or contract of indemnity between 'insurer' and 'insured'. Insurer is one party which agrees to provide protection against loss or damage in the form of promise to pay for such loss to other party known as 'insured' in consideration for a fixed sum of money known as 'premium'. The terms and conditions of such insurance contract in the written is called 'Insurance Policy'. Insurance are of the two types, namely Life Insurance and General Insurance.

6.2 Life Insurance Business

In case of Life Insurance, the insurer guarantees to pay a certain sum of money to the assured on completing a stipulated period or in the event of the death**,** to his legal representative. It covers risks and gives protection for the investment. Section 2(II) of the Insurance Act, 1938 has defined 'Life Insurance Business" as the business of effecting contracts of insurance upon human life, including any contract whereby the payment of money is assured on death or the happening of any contingency dependent on human life, and any contract which is subject to payment of premiums for a term dependent on human life and shall be deemed to include a) The granting of disability and double or triple indemnity accident benefits, if so provided in the contract of insurance; b) The granting of annuities upon human life; and c) The granting of superannuation allowances and annuities payable out of any fund applicable solely to the relief and maintenance of person engaged or who have been engaged in any particular profession, trade or employment or of the dependents of such persons.

6.3 Statutory Books and Subsidiary Books

A] Statutory Books –

The Insurance Act, 1938, requires the following books to be maintained by all insurance company:

I. Register of Policies

It contains all the details in respect of each policy such as name and address of the policy holder, the date when the policy was affected and a record of any assignment of the policy.

II. Register of Claims

All the particulars of claims are recorded – date of claim, name and address of claimant, the date on which the claim was discharged, the case of a claim which is rejected and reasons for rejection.

III. Register of Agents

It contains all the information of licensed insurance agents such as name and address of the agent, date of appointment, etc.

B] Subsidiary books

Apart from statutory books, the insurance companies also maintain the following books**:**

I. Ledgers – Life insurance Fund ledger; revenue ledger and miscellaneous ledger

II. Cash books – Receipt**s** cash books and expenditure cash books.

III. Journal – Journal for recording transactions relating to outstanding premium **,** claims and inter-departmental transfer.

IV. First year premium book

V. Renewal premium book

VI. Surrender policy book

6.4 Preparation of Financial Statements

The financial statement of the life insurance companies consist of revenue account, profit & loss account and balance sheet. These statements to be prepared in accordance with the provisions of IRDA (Preparation of financial statements and auditors' Report of insurance companies) Regulations, 2002 and comply with the requirements of schedule 'A'. The insurer needs to prepare Revenue A/c in form A-RA; profit & loss A/C in form A-PL and Balance sheet in form A-BS. The revenue account contains total 4 schedules**-** schedule1 – Premium; schedule 2- Commission expenses; Schedule 3- Operating expenses and schedule 4 – Benefits paid. It also shows the items having no specific schedule such as income from investments, interim bonus paid; provision for doubtful debts; tax and such other provisions. The bottom section of revenue account exhibits appropriators of surplus such as transfer to shareholders accounts, transfer to other reserves, etc. The remaining balance of revenue account is transferred to life insurance fund account. The profit and loss account show all expenses and income not directly related to insurance business. The balance sheet of life insurance companies are prepared in 'vertical form' having two sections – sources of fund and application of fund. The schedule 5, 6 and 7 deals with sources of fund and schedule 8 to schedule 15 shows the application of Fund. The contingent liabilities are disclosed as part of financial statement by way of notes to balance sheet.

Form B-BA

Name of the insurer
Registration No. and Date of Registration with the IRDA
Revenue Account for the year ended 31st March, 20…

Particulars	**Schedule**	**Current Year (RS'000)**	**Previous Year (Rs'000)**
1. Premiums Earned – Net	1		
2. Profit /Loss on Sale/Redemption of Investments			
3. Other (to be Specified)			
4. Interest, Dividends and Rent – Gross			
Total (A)			
1. Claims Incurred (Net)	2		
2. Commission	3		
3. Operating Expenses related to Insurance Business	4		
Total (B)			
Operating Profit/ (Loss) from Fire / Marine /Miscellaneous Business C = (A-B)			
Appropriations			
Transfer to Shareholder Account			
Transfer to Catastrophe Reserve			
Transfer to other Reserves (to be specified)			
Total (c)			

Note: See Notes appended at the end of Form B-PL

FORM B-PL

Name of the Insurer

Registration No. and Date of Registration with the IRDA

Profit and Loss Account for the year ended 31st March, 20…

Particulars	Schedule	Current Year (RS'000)	Previous Year (Rs'000)
1. Operating Profit / (Loss)			
a) Fire insurance			
b) Marine insurance			
c) Miscellaneous insurance			
Income from Investment			
Interest, Dividend and Rent – Gross			
Profit on Sale of Investments			
Less: Loss on sale of Investments			
3. Other income (to be specified)			
Total (A)			
4. Provisions (other than taxation)			
a) For Diminution in the Value of Investments			
b) For Doubtful Debts			
c) Others (to be specified)			
Other Expenses			
a) Expenses Other Than Those Related to Insurance Business			
b) Bad Debts Written off			
c) Others (to be specified)			
Total (B)			
Profit Before Tax			
Provision for Taxation			
Appropriations			
a) Interim Dividend Paid During the Year			
b) Proposed Final Dividend			
c) Dividend Distribution tax			
d) Transfer to any Reserves/ 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 conducted 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 claims at the year end.

e) Fees and expenses connected with claims shall be included in claims.

f) Under the sub-head "others" shall be included items like foreign 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 would be included under 'advance taxes paid and taxes deducted at source".

h) Income from rent shall include only the realized rent. It shall not include any national rent.

FROM B-BS

Name of insurer:

Registration No. and Date of Registration with the IRDA:

Balance Sheet as at 31st March, 20…

Particulars	**schedule**	**Current Year (RS'000)**	**Previous Year (Rs'000)**
Sources of Funds			
Share Capital	5		
Reserves and Surplus	6		
Fair Value Change Account			
Borrowings	7		
Sub Total			
Application of Funds			
Investments	8		
Loans	9		
Fixed Assets	10		
Current Assets			
Cash and Bank Balance	11		
Advances and Other Assets	12		

Sub Total (A)		
Current Liabilities	13	
Provisions	14	
Sub Total (B)		
Net Current Assets (C)= (A-B)		
Miscellaneous Expenditure (to the extent not written off or adjusted)	15	
Debit Balance Profit and Loss account		
Total		

The preparation of final account for insurance company can be understood with the help of the following comprehensive example.

Example:1 The following balances from part of the trial balance of the All People's Assurance Co. Ltd as on 31st March 2012.

Amount of life Assurance Fund at the beginning of the year Rs. 14,70,562 thousand; claims by death Rs 76,980 thousand; claims by maturity Rs 56,420 thousand; premiums, Rs 2,10,572 thousand, Expenses of management Rs 19,890 thousand; commission Rs 26541 thousand; consideration for annuities granted Rs 10,712 thousand; interests, dividends and rent Rs 52461 thousand; Income tax paid on profit Rs 3,060 thousand; surrenders Rs 21,860 thousand; annuities Rs 29,420 thousand; bonus paid in cash, Rs 9,450 thousand; bonus paid in reduction of premium Rs 2,500 thousand; preliminary expenses balance Rs 600 thousand; claims admitted but not paid Rs 2380 thousand; capital paid up Rs 14,00,000 thousand; government securities Rs 24,90,890 thousand; sundry fixed assets Rs 4,19,110 thousand.

Prepare revenue account and the balance sheet after taking into account the following:-

a) claims covered under reinsurance, Rs 10,000 thousand.

b) Further claims intimated, Rs 8,000 thousand.

c) Further bonus utilised in reduction of premium, Rs 1,500 thousand

d) Interest accrued Rs 15,400 thousand;

e) Premiums outstanding Rs 7,400

Solution

All People Co Ltd
Revenue Account for the year ended 31st March, 2012

Particulars	**Schedule**	**Rs, 000**
Premium earned net	1	2,19,472
Income from investments		67,861
Other income: Consideration for annuities granted		10,712
Total (A)		**2,98,045**
Commission	2	25,541
Operating expenses related insurance business	3	19890
Provision for tax		3,060
Total (B)		**49491**
Befit Paid net	4	1,96,130
Total (C)		1,96,130
Surplus(D)= (A)- (B)-(C)		**52,424**
Balance being funds for future appropriation		**52,424**
Total (D)		**52,424**

Balance Sheet as on 31st March 2012

Sources of funds	**Schedule**	**Rs (000)**
Share capital	5	13,99,400
Policyholders' funds		
Life assurance funds		14,70,562
		28,69962
Funds or future appropriation		52,424
Total		**29,22,386**
Application of Funds		
Investments	8	24,90,890
Fixed Assets	10	4,19,110
Advance and other assets	12	32,800
Sub Total (A)		**32,800**
Current liabilities	13	20,414
Sub Total (B)		**20,414**
Net current assets (C)= (A)-(B)		13,386
Total		**29,22,386**

SCHEDULE-1

Premium	**Rs (000)**
Premiums Earned net	2,19,472

SCHEDULE-2

Commission Expenses	**Rs (000)**
Commission expenses	26,541

SCHEDULE-3

Operating Expenses related to insurance businnes	**Rs (000)**
Operating Expenses related to insurance businnes	19,890

SCHEDULE-4

Benefit Paid (net)	**Rs (000)**
1. Insurance claims	
a) Claims by death	84,980
b) Claims by maturity	56,420
c) Annuities	29,420
d) Surrenders	21,860
e) Bonus in cash	9,450
f) Bonus in reduction of premium	4,000
2. Amount ceded in reinsurance (Claims by death)	(10000)
Total	**1,96,130**

SCHEDULE-5

Share capital	**Rs (000)**
Called up and paid up	19,890
Less: Preliminary expenses	(600)
Total	**19,99,400**

SCHEDULE-8

Investment	**Rs (000)**
Government Securities	24,90,890

SCHEDULE-10

Fixed Assets	**Rs (000)**
Fixed Assets	4,19,110

SCHEDULE-12

Advance and other assets	**Rs (000)**
Interest accrued on investment	15,400
Outstanding Premium	7,400
Due from reinsurer	10,000
Total	**32,800**

SCHEDULE-13

Current liabilities	**Rs (000)**
Claims outstanding	20,414

Working Note:

Premium received	**Rs (000)**
Premium received	2,10,572
Add: Outsatnding	7,400
Covered by bonus utilised for reduction of premium	1,500
Premium Earned net	**2,19,472**

Income from investment	**Rs (000)**
Interest dividends and rents	52,461
Add: Interest accrued	15,400
Income from investment	**67,861**

Example 2: A life insurance Corporation disclosed a life Insurance Fund of Rs 40, 00,000 and the balance sheet total Rs 90, 00,000 on 31st march 2012, before taking the following into consideration:

(i) A claim of Rs 20,000 was intimated and admitted but not paid during the year.
(ii) A claim of Rs 12,000 outstanding in the books for 10 years is written back.
(iii) Interest on securities accrued Rs 1,600, but not paid during the year.
(iv) Rent of the own building occupied Rs 4,000.
(v) Premium of Rs 1,200 is payable under reinsurance.

Pass necessary journal entries for above omissions. Show correct Life Insurance Fund and balance sheet total after above adjustments.

Solutions

Journal

S. No	**Particulars**	**Dr. (Amt)**	**Cr. (Amt)**
1	Claims A/c Dr.	20,000	
	To Outstanding claims A/c		20,000
	(Being adjustment made for claims intimated and admitted but not paid)		
2	Outstanding claims A/c Dr	12,000	
	To Revenue A/c		12,000
	(Being outstanding claims written back)		
3	Accrued interest A/c Dr	1,600	

	To Interest A/c		1,600
	(Being Interest on securities brought to account)		
4	Rent A/c Dr	4,000	
	To Revenue A/c		4,000
	(Being rent of own building)		
5	Premium A/c Dr	1,200	
	To Other Insurance A/c		1,200
	(Being premium paid under reinsurance)		

Statement Showing Correct Life Insurance Fund

S. No	**Particulars**	**Dr. (Amt) Decrease**	**Cr. (Amt) Increase**
1	Life insurance fund balance before adjustments	------------	40,00,000
2	Claims account	20,000	
3	Revenue account		12,000
4	Interest account		1,600
5	Rent account, revenue account	4,000	4,000
	Total	**25,200**	**40,17,600**

Correct Life insurance fund after adjustments = 40,17,600
- 25,200

39,92,400

Effect of Entries on Balance Sheet

S. No	**Account Effected**	**Liabilities**		**Assets**	
		Increase	Decrease	Increase	Decrease
1	Claims	20,000	20,000	---	----
2	Revenue	12,000	12,000	-----	----
3	Interest	1,600	----	1,600	-----
4	Rent and Revenue	-----	-----	-----	----
5	Premium	1,200	1,200	-----	-----

6.5 Procedure to Ascertain Profit or Loss of the Life Insurance Business

The profit or loss of the life insurance business is to be ascertained after every two years by preparing 'valuation balance sheet'**.** In case of life insurance business, the claims arise either on death or expiry of policy period. Hence, a deficiency may arise due to the difference between the present value of the future premium to be received and the present value of future liability on all policies in force. This deficiency is termed as 'net liability'. The estimation of such liability is done by mathematicians well versed in tedious calculations of life insurance – known as 'actuaries'. After the valuation of net liability by appointed actuary, and it is compared with Life Assurance fund by preparing Valuation Balance sheet , in order to find out profit or loss of a Life Insurance Company.

Valuation Balance sheet of ------------- as at---------------

Particulars	**Rs.**	**Particulars**	**Rs.**
NET liabilities	Xxx	Life insurance	xxx
Surplus (if any)	Xxx	Deficit (if any)	xxx
	Xxxx		**xxxx**

Example-3

Gipsy Life Insurance Company provides following information to prepare Valuation Balance Sheet and profit distribution statement for the year ended on 31st March 2012.

Particulars	**Amount (Rs)**
Life insurance fund (as on 1-4-2012)	1,83,865
Interim Bonus Paid	27,500
Revenue account balance (as on 31-3-12)	2,64,000
Net Liability as per Valuation (as on 31-3-12)	1,81,500

The company declared a reversionary bonus of Rs. 210 per Rs. 1,000 and gave the policy holders options to take bonus in cash Rs. 120 per Rs. 1,000. Total business of the company was Rs. 7, 48,000. The company issued with profit policy only, ¾ of the policy holders in value opted for cash bonus.

Solution

Gipsy Life Insurance Company

Valuation Balance sheet as at 31-3-12

Particulars	Rs	Particulars	Rs.
Net Liabilities	1,81,500	Life Insurance Fund	2,64,000
Surplus	82,500		
Total	**2,64,000**		**2,64,000**

Profit Distribution Statement

Particulars	Rs
Surplus as per Valuation Balance sheet	82,500
Add: Interim Bonus Paid	27,500
Profits available for distribution	**1,10,000**
Share of policy holders (95%)	1,04,500
Less: Interim Bonus Paid	27,500
Amount due to policy holders	**77,000**
Shares of shares holders (5%)	5,500

Note: 95% of the surplus must be utilized for the benefit of policy holders and 5% of the surplus to be given to shareholders.

6.6 General Insurance Business

General Insurance Business is the business other than Life Insurance. It is carried by General Insurance Corporation of India through its subsidiary companies and many private companies also involve in General Insurance business. Section 2(60) of the Insurance Act 1938 has defined 'General Insurance Business' as fire, marine or miscellaneous insurance business, whether carried on singly or in combination with one or more of them. Fire insurance business means the business of effecting, otherwise than incidentally to some other class of insurance business, contracts of insurance against loss by or incidental to fire or other occurrence customarily included among the risks insured against the fire insurance policies. Marine Insurance Business means the business of effecting contracts of insurance upon vessels of any descriptions, including cargoes, freights and other interests which may be legally insured in or in relation to such vessels, cargoes and freights, goods wares, merchandise and property of whatever description insured for any transit by land or water, or both and whether or not including warehouse risks or similar risks in addition or incidental to such transit, and includes any other risks customarily included among the risks insured against in marine insurance policies.

6.7 Some Important Points in Final Accounts of General Insurance

6.7.1 Reserved for Unexpired Risk

General Insurance Policies are taken for one year period and so risk is covered for 12 months from the date of insurance. The policies are issued throughout the year and remain in force even after the close for the current financial year and the entire premium for his period is collected in advance. For e.g. this period is collected in advance. For example, a policy is issued on 15 January 2006 and it will be in force up to 14 January 2007 so the premium received on such policy covers partly current year 2005-06 and partly next year 2006-07. The risk may happen on any day during the lifetime of policy. The premium received on individual policy is not separated on time basis. Therefore**,** a provision against unexpired risk is made to meet future claims arising under such policies.

Reserves for unexpired risks are laid down as follows

Fire and miscellaneous business, 50% of the premium, net of reinsurance, during the preceding 12 months. Marine cargo business, 50% of the premium, net of re-issue during the preceding 12 months. Marine hull business 100% of the premium, net of re-issue during the preceding 12 months. However, an insurance company may keep additional reserve if it feels so. The treatment of reserve for unexpired risk can be better understood with help of following example.

Example:4 On 31st March 2012 the books of Insurance Company contained the following particulars in respect of Fire Insurance Business.

Particulars	Amount
Reserve for unexpired risk on 31st March 2011	20,00,00
Additional Reserve, 31st March 2011	4,00,00
Claims paid	25,60,000
Estimated liability related to outstanding claims	
On 31st March, 2011	2,60,00
On 31st March, 2012	3,60,00
Expenses of management including Rs 1,20,000 legal expenses connection with claim	11,20,000
Premium on reinsurance ceded	3,00,000
Reinsurance recoveries	80,000
Premiums	44,80,000
Interest and dividends	2,58,000
Income tax thereon	20,080
Profit on sale of investment	44,000
Commission	6,08,000

Prepare in prescribed form the fire insurance revenue account for the year 2011-12, reserving 50% of the premium for unexpired risks and keeping an additional reserve of Rs 4,00,000. Assume that one- fourth of the premium and claims are applicable to business outside India.

Solution

Revenue Account

For the year ended 31st March 2012

Particulars	Schedule	Amount (Rs)
Premium earned (net)	1	40,90,000
Profit on sale of investment		44,000
Interest and dividend		2,58,000
Total (A)		**43,92,000**
Claim incurred (net)	2	27,00,000
Commission	3	6,08,000
Operating expenses related to insurance	4	10,00,000
Total (B)		43,08,000
Operating profit C=A-B		84,000

SCHEDULE-1 Premium Earned (net)

Particulars	Amount (Rs)
Premium	44,80,000
Less: Premium on reinsurance ceded	3,00,000
Net premium	41,80,000
Add: Operating Reserve for unexpired risk	20,00,000
	61,80,000

Less: Closing Reserve for unexpired Risk	20,90,000
Total premium earned (net)	**40,90,000**

SCHEDULE-2 Claims incurred (net)

Particulars	Amount (Rs)
Claims Paid	25,60,000
Less: Reinsurance recoveries	80,000
Net claims	24,80,000
Add: Outstanding claims on 31-3-2012	3,60,000
	28,40,000
Less: Outstanding claims on 31-3-2011	2,60,000
	25,80,000
Add: Legal Expenses	1,20,000
Total claims incurred (net)	**27,00,000**

SCHEDULE-3 Commission (net)

Particulars	Amount (Rs)
Commission Paid (Direct)	25,60,000

SCHEDULE-4 Operating expenses related to insurance business

Particulars	Amount (Rs)
Expenses of Management (11,20,000-1,20,000)	10,00,000

6.7.2 Accounting Treatment

The opening balance of reserve for unexpired risk is credited to revenue account and closing balance is debited to revenue account.

Example 5 Give the journal entries and unexpired risk reserve account from the following information of Biji General Insurance Company Ltd. for the year ended on 31st March 2012.

I. Total reserve for unexpired risk as on 31st March 2012.

Marine Insurance policies	Rs. 285
Fire Insurance policy	Rs. 380
Miscellaneous Insurance policies	Rs. 95
Total	**Rs. 760**

II. Reserves to be created for the year ending 31st March 2012:
Marine Insurance policy – 100% of net premium
Fire and miscellaneous - 50% of net premium insurance policies.

III. During the year the premium received:

Marine Insurance business	Rs. 345
Fire insurance business	Rs. 817
Miscellaneous insurance business	Rs. 228

Premium collected from other insurance companies in respect of risk undertaken

Marine insurance business	Rs. 133
Fire insurance business	Rs. 95
Miscellaneous insurance business	Rs. 76

V. Premium paid to other insurance companies on business ceded

Marine insurance business	Rs. 127.3
Fire insurance business	Rs. 81.7
Miscellaneous insurance business	Rs. 133

Solution

In the Books of Biji General Insurance Company Ltd.

Journal Entries

Date	Particulars	Dr	Cr
31st March 2012	Unexpired Risk Reserve (Fire) A/C Dr	380	
	Unexpired Risk Reserve (Marine) A/C Dr	285	
	Unexpired Risk Reserve Dr	95	
	To Fire Revenue A/C		380
	To Marine Revenue A/C		285
	To Revenue A/C		95
	[Being opening balance of reserve is credited to revenue A/C]		
	Marine Revenue A/C (note l) Dr	347.7	
	To Unexpired Risk Reserve A/C		347.7
	[Being the reserve created at 100% of net premium income]		
	Fire Revenue A/C (note l) Dr	415.15	
	To Unexpired Risk Reserve A/C		415.15
	[Being the reserve created at 50% of net premium income)		
	Miscellaneous Revenue A/C (note I) Dr	85.5	
	To Unexpired risk reserve A/C		85.5
	[Being the reserve created at 50% of net premium income)		

Calculation on Net Premium Income

Particulars	**Marine**	**Fire**	**Miss**
Premium Collected From Policy Holders	342	817	228
Premium Collected from other Insurance Company	133	95	76
Less: Premium Paid to other Insurance Company	(127.3)	(81.7)	(133)
	347.7	**830.3**	**171**
Percentage of Reserve	100%	50%	50%
Amount of Reserve to be Created	347.7	415.15	85.5

6.8 Preparation of Financial Statements

The general insurance companies in India prepares its financial statements in accordance with provision of IRDA Regulations, 2002. The financial statements consist of revenue account, profit and loss account and vertical balance sheet in form B-RA, form B-PL and Form B-BS respectively. Revenue accounts for fire, marine and miscellaneous insurance business to be prepared separately. Revenue account contains schedule-1, schedule-2, schedule-3, and schedule -4 and given operating profit or loss from insurance business which is transferred to profit and loss account. Items not directly related to the insurance business are exhibited in profit and loss account for e.g. transfer fees, diminution in the value of investment, bad debts written-off. Balance sheet contains source of funds and application of fund. Sources of funds consists of schedule-5, schedule-6 and schedule-7 and application of funds consist of schedule-8 to schedule 15. Contingent liabilities are disclosed at the bottom of balance sheet.

FROM A-RA

Name of the Insurer:

Registration No. and Date of Registration with the India:

Revenue Account for the year ended 31st March, 20…

Policyholder's Account (Technical account)

Particulars	Schedule	Current Year (RS'000)	Previous Year (Rs'000)
Premiums Earned – Net			
(a) Premium	1		
(b) Re-insurance Ceded			
(c) Re-insurance Accepted			
Income from Investments			
(a) Interest, Dividends and Rent –Gross			
(b) Profit on Sale / Redemption of Investments			
(c) (Loss on Sale / Redemption of Investments)			
(d) Transfer / Gain on Revaluation /Change in Fair value			
Other Income (to be specified)			

Total (A)	2
Commission	3
Operating Expenses Related to Insurance Business	
Provision for Doubtful Debts	
Bad Debts Written off	
Provision for tax	
Provision (other than taxation)	
(a) For Diminution in the Value of Investment (Net)	
(b) Other (to be specified)	
Total (B)	
Benefits Paid (Net)	4
Interim Bonuses Paid	
Change in Valuation of Liability in Respect of life Policies	
(a) Gross**	
(b) Amount Ceded in Reinsurance	
(c) Amount Accepted in Reinsurance	
Total (c)	
Surplus / (Deficit((D) = (A) - (B) - (C)	
Appropriations	
Transfer to Shareholders' Accounts	
Transfer to Other Reserves (to be specified)	
Balance Being Funds for Future Appropriations	
Total (D)	

Notes:

***** Represents the deemed realized 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)].

FROM A-PL

Name of the Insurer
Registration No. and Date of Registration with the IRDA
Profit and Loss Account for the year ended 31st March, 20...
Shareholders' Account (Non-technical Account)

Particulars	Schedule	Current Year (RS'000)	Previous Year (Rs'000)
Amounts Transferred From /to the Policyholders' Account (Technical account)			
Income From Investments			
(a) Interest, Dividends and Rent – Gross			
(b) Profit on Sale /Redemption of Investments			
(c) (Loss on Sale/ Redemption on Investments)			
Other income (to be specified)			
Total (A)			
Expenses Other Than Those Directly Related to the Insurance business			
Bal Debts Written off			
Provisions (other than taxation)			
(a) For Diminution in the Value of Investments (Net)			
(b) Provisions for Doubtful Debts			
(c) Others (to be specified)			
Total (B)			
Profit / (Loss) Before Tax			
Provision for Taxation			
Profit / (Loss) After Tax			
Appropriations			
(a) Balance at the Beginning of The Year			
(b) Interim Dividends Paid During the Year			
(c) Proposed Final Dividend			
(d) Dividend Distribution on Tax			
(e) Transfer to Reserves/ Other Accounts (to be specified)			
Profit Carried… to the Balance Sheet			

Notes to Form A-RA and A-PL:

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance Premiums.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year end.

(d) Items of expenses and income in excess of one per cent of the total premiums (less re-insurance) or Rs. 5, 00,000 whichever is higher, shall be shown as a separate line item.

(e) Fees and expenses connected with claims shall be included in claims.

(f) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(g) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income-tax deducted at source being included under "advance taxes paid and taxes deducted at source".

(h) Income from rent shall include only the realized rent. It shall not include any notional rent.

FORM A-BS

Particulars	Schedule	Current Year (RS'000)	Previous Year (Rs'000)
Sources of Funds			
Shareholders' Funds:			
Share Capital	5		
Reserves and Surplus	6		
Credit / [Debit] Fair Value Change Account			
Sub Total			
Borrowings	7		
Policyholders' Funds:			
Credit/ [Debit] Fair Value Change Account			
Policy Liabilities			
Insurance Reserves			
Provision for Linked Liabilities			
Sub Total			
Funds for Future Appropriations			
Total			
Application of Funds			
Investments			
Shareholders	8		
Policyholders	8a		

Assets Held to Cover Linked Liabilities	8b	
Loans	9	
Fixed Assets	10	
Current Assets		
Cash and Bank Balances	11	
Advances and other Assets	12	
Sub Total (A)		
Current Liabilities	13	
Provisions	14	
Sub Total (B)		
Net Current Assets (C) = (A)- (B)		
Miscellaneous Expenditure (to the extent not written off or adjusted)	15	
Debit Balance in Profit and Loss Account (Shareholders' Account)		
Total		

The process of preparation of final account of General Insurance companies can be better understood with help of following example.

Example 6 From the following figures relating to the Metro Life Insurance Company Ltd. Prepare its Revenue Account for the year ended 31st March, 2013 and Balance Sheet as on that date:

Particulars	Rs. In 000s
2,00,00,000 Shares @ 10	2,00,000
Claims Under Policies and Outstanding Less Received on Re-assurance	45,00,000
Life Assurance Fund on 1st April, 2012	4,80,00,000
Investment Fund on 1st April, 2012	50,00,000
Expenses of Management	15,00,426
Investments	5,10,00,000
Freehold and Leasehold Property	25,00,000
Unpaid Dividends	51,790
Outstanding Premiums(Net)	6,03,200
Claims Admitted or Intimated but not Paid	30,00,000
Outstanding Interest	5,90,000
Surrenders	2,58,950
Annuities	30,000
Premium Less Re-Insurance	75,00,000
Consideration for Annuities Granted	50,500
Bonus in Reduction of Premium	4,000
Gain on Redemption of Debentures	20,000
Interest, Dividends and Rents Received	32,00,336
Interests Accrued	3.17,000

Income Tax	2,80,148
Transfer and other Fees	6,430
Agents Balance Outstanding	1,45,904
Furniture and Fittings	90,500
Loan on Company's Polices Within Their Surrender Value	49,00,000
Cash in Hand and Cash at Bank	3,64,000
Stamps in Hand	7,322
Cheques Paid into Bank and in Course of Realisation	49,000
Cheque Issued but not Presented for Payment	66,520
Sundry Creditors	44,874
Premium Received in Advance	1,00,000
Commission Paid	1,00,000
Income tax on Interest and Dividends	1,20,000

Solution

Metro Life Assurance Company Ltd.
Revenue Account
For the year ended 31st March, 2013

Particulars	**Schedule**	**Rs (000s)**
Premium Earned (Net)	1	75,00,000
Income From Investments:		
Interest, Dividend and Rents-Gross		33,20336
Other Income:		
Consideration for Annuities Granted		50,500
Transfer and other Fees		6,430
Total (A)		1,08,77,266
Commission	2	1,00,000
Operating Expenses Related to Insurance	3	15,00,426
Total(B)		16,00,426
Benefit Paid (Net) (C)	4	47,92,950
Surplus (D)= (A)-(B)		44,83,890

Balance Sheet
As on 31st March, 2013

Particulars	**Schedule**	**Rs (000)**
Sources of Funds		
Share Capital	5	2,00,000

Reserve and Surplus	6	50,20,000
Life Assurance Fund		4,80,00,000
Funds for Future Appropriation		44,83,890
Total		**5,77,03,890**
Application of Funds		
Investments	8	5,10,00,000
Loans	9	49,00,000
Fixed Assets	10	25,56,252
Cash and Bank Balance	11	3,53.802
Advances and Other Assets	12	20,56.252
Sub-Total		24,10,054
Current Liabilities	13	31,96,664
Net Current Assets (C)= (A)-(B)		-7,86,610
Total		**5,77,03,890**

Example 7 The Profit and loss account of a Fire Insurance company shows the profit of Rs 3, 00,000 for the year ending 31st March 2012 before taking into account the following:

Particulars	Amount
1. Claims intimated but not admitted	55,000
2. Claims outstanding for ten years, now written off	30,000
3. Reinsurance recoveries	23,000
4. Outstanding premium	80,000
5. Bonus utilised in reduction of premium	10,000
6. Interest accrued on securities	5,000
7. Agent's commission to be paid	7,500

Pass the journal entries the above commissions and show the net profit of the company after making the above adjustment.

Solutions

Journal Entries

S. No	Particulars	Dr (Rs)	Cr(RS)
1	Claims A/c Dr	55,000	
	To Outstanding claims A/c		55,000

	(Being outstanding claims intimated)		
2	Outstanding Claims A/c Dr	30,000	
	To Other income A/c		30,000
	(Being outstanding claim written off)		
3	Other Insurance Co Dr	30,000	
	To Claims A/c		23,000
	(Being claims A/c)		
4	Outstanding Premium A/c Dr	80,000	
	To Premium A/c		80,000
	(Being outstanding premium)		
5.	Bonus in Reduction of Premium A/c Dr	5,000	
	To Interest A/c		5,000
	(Being interest accrued on securities)		
7.	Commission A/c Dr	7,500	
	To Outstanding commission A/c		7,500
	(Being Commission A/c)		

Statement Showing Effect on Net Profit

S. No	**Particulars**	**Dr (Rs) Increase**	**Cr (Rs) Decrease**
	Net profit before taking into account the adjustment entries	-----	300,000
1	Claims A/c	55,000	---
2	Other income A/c	-----	30,000
3	Claims A/c	----	23,000
4	Premium A/c	----	80,000
5	Bonus in reduction of premium A/c	10,000	10,000
6	Interest A/c	---	5,000
7	Commission A/c	7,500	----
8	Reserve for unexpired risk (50% of 80,000 + 10,000)	45,000	
		1,17,500	4,48,000
	Net Profit after adjustment (4,48,000-1,17,500)	3,30,500	
	Total	**4,48,000**	**4,48,000**

6.9 Summary

Insurance is a contract of indemnity whereby the insurer undertakes, to make good the loss suffered by the insured against a specified risk or any other contingency for a consideration of a fixed sum of money. The business of insurance in India is governed by The Insurance Act, 1938 and regulated under the framework of Insurance Regulation and Development Authorities Act, 1999. In case of life insurance a specified amount becomes payable on the death of the insured or on maturity of the policy. General insurance covers losses caused by fire, accident and loss incidental to marine business. The insurance companies in India need to maintain statutory books i.e. register of agents. Besides these books they also maintain subsidiary books i.e. ledgers, journal cash book etc.

6.10 Key Terms

Premium: The amount paid by the policy holder to the insurance company at regular intervals or at one stroke**.**

Claims: The amount payable by an insurer against the policy either on maturity or on the death of the policy holder.

Reinsurance: The insurance company transfer part of its risk on another insurance company in anticipation for commission against it is known as reinsurance.

Annuities: A fixed sum of money which the insurance company pays periodically in a series to policy holder in return for a lump sum paid in advance.

Reserve for Unexpired Risk: In case of general insurance, the reserve for unexpired risk is created every year against the premium received in advance, in order to meet any loss that may a**rise** on any day during the lifetime of policy.

6.11 Review Questions

1. The following trial balance was extracted from the books of Bhart Life Assurance Co. Ltd as on 31st March, 2012.

Particulars	Dr	Cr
Share Capital @10 each		1,60,000
Life Assurance Fund as on 1st April, 2000		29,72,300
Dividends Paid	15,000	
Bonus to Policy Holders	31,500	
Premium Received		1,01,500
Claims Paid	1,97,000	
Commission Paid	9,300	
Management Expenses	32,300	
Mortgage in India	4,92,200	
Interest and Dividends Received		1,12,700
Agents' Balances	9,300	
Freehold Premises	40,000	
Investments	23,05,000	
Loan on Company's Policy	1,73,600	
Cash on Deposit	27,000	
Cash in Hand and on current A/c	7,300	
Surrenders	7,000	
	33,46,500	33,46,500

You are required to prepare the company's Revenue Account for the year ended 31st March, 2000 and its Balance Sheet as on that date after the following matters into consideration:

a) Claims admitted but not paid — Rs 9,300

b) Management Expenses Due — Rs 200

c) Interest accrued — Rs 19,300

d) Premiums outstanding — Rs 12,000

2. From the following details prepare the Revenue Account, Profit and Loss Account and the Balance Sheet of Moonshine Insurance Co. Ltd., carrying on marine insurance business, for 15 months ended 31st March, 2012.

Share Capital	Rs	15, 00,000
Balance of Marine Fund as on 1st January, 2012		7, 60,000
Unclaimed Dividends		2,400
Profit and Loss (Cr)		2, 40,000

Sundry Creditors	12600
Agents' Balance (Dr)	1, 46,400
Interest Accrued but not due	8,200
Due to Reinsurers	60,000
Furniture and Fixtures (Cost Rs 12,600)	8,400
Stock of Stationary	2,500
Expenses of Management	2, 20,000
Foreign Taxes and Insurances	12,300
Outstanding Premium	21,200
Donation Paid	8,600
Advance Income Tax Payment	62,000
Sundry Debtors	9,200
Govt of India Securities	9,20,000
Debentures of Public Bodies	1,80,000
Shares in Limited Companies	3,60,000
State government Securities	8,80,000
Claims less Reinsurances	10,60,000
Premium Less Reinsurances	12,40,000
Commission Paid	62,400
Interest and Dividend Paid	2,40,000
Transfer Fees Received	6,000
Cash and Bank Balances	94,000

Out claims on 31 March, 2011 were Rs. 1, 40,000. Depreciation of furniture to be provided at 20% per Annum.

3. Explain the purpose of creating reserve for unexpired risk. State its accounting treatment.
4. Define the term life insurance. Explain its various financial statements with suitable examples.
5. Define the term General Insurance. Explain its various accounting treatments with suitable examples.
6. Write a short note on:

A. Annuity
B. Reinsurance
C. Claims

6.12 Further Reading

1. Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.

2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.

3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.

4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency, Calcutta.

5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

Lesson-7

DOUBLE ACCOUNT SYSTEM

Dr. Sushil Kumar

7.0 Objectives

After study of the present chapter the student will be able to:

1. understand the concept of double account system;

2. understand the accounting treatment of electricity companies;

3. understanding difference between double account system and double entry system and

4. to explain some key terms used in public utility accounting.

7.1 Introduction

Public utility companies, are usually incorporated under special Acts of Parliament and generally enjoy monopolistic rights, in their business of rendering service to the general public. The form of presentation of final accounts of such enterprises is prescribed by the special Act under which companies are registered.

7.2 Meaning of Double Account System

Double account system is a system of presenting final accounts where a firm prepare two balance sheets instead of one.

7.2.1 Salient features of Double Account System

1. Balance sheet is prepared in two parts i.e.

- **Capital account**

✓ It is a receipt and expenditure on capital account.

✓ Shown in three columns i.e. Opening, during the year, closing.

✓ Preliminary expenses on formation are treated as capital expenditure.

✓ Premium received on issue of shares or debentures is deducted from the proceeds of the issue and the proceeds are shown net.

- **General Balance-sheet**

2. Profit and Loss Account in two parts i.e.

- **Revenue Account**

Similar to P&L A/c but it should be noted that depreciation is debited to this account and credited to depreciation reserve and not to asset account.

- **Net Revenue Account**

Similar to P&L Appropriation A/c but it should be noted that interest on loans and debentures are treated as an appropriation and therefore debited to this account. This is done because debentures and loans are considered as part of the capital of the concern.

7.3 Difference between Double Account System and Single Account System

1. **Preparation of Balance Sheet**

In case of single account system only balance sheet is prepared giving details of assets and liabilities of the business. In case of double account system, two balance sheets are prepared.

2. **Objective of Balance Sheet**

Objective of balance sheet in case of single account is to present financial position of company on a particular date. While the objective of balance sheet in case of double account is to give detail regarding fixed capital raised and it utilization for purchase of assets.

3. Double account system is necessary only for Govt. service rendering organisation but double entry system is applicable for all types of organisation.

4. **Presentation of Fixed Assets**

In case of single account, fixed assets are presented after deducting depreciation in the balance sheet. While in case of double account system assets are shown at cost in capital account and depreciation with its reinvestment will be shown in general balance sheet.

5. **Title of the Income Statement**

In case of single account system, the income statement is prepared two parts P & L a/c and P & L Appropriation A/c. In case of double account system, the income statement comprises two parts namely, Revenue A/c and Net Revenue A/c.

7.4 Difference between Double Entry and Double Account System

Double account system should not be confused with double entry system. Double entry is a method book keeping while double system is a method of presentation of final accounts. As a matter of fact fundamental principal of double entry shall be applicable in both double account and double entry system. It is the only way of presentation of final accounts which differentiate between these two terms.

7.5 Historical Background of Legislative Initiatives

a) The Indian Electricity Act, 1910

· Provided basic framework for electric supply industry in India.

· Growth of the sector through licensees. Licence by State Govt.

· Provision for licence for supply of electricity in a specified area.

· Legal framework for laying down of wires and other works.

· Provisions laying down relationship between licensee and consumer.

b) The Electricity (Supply) Act, 1948

· Mandated creation of SEBs.

· Need for the State to step in (through SEBs) to extend electrification (so far limited to cities) across the country.

Main Amendments to the Indian Electricity Supply Act

· Amendment in 1975 to enable generation in Central sector.

· Amendment to bring in commercial viability in the functioning of SEBs – Section 59 amended to make the earning of a minimum return of 3% on fixed assets a statutory requirement (w.e.f 1.4.1985) .

· Amendment in 1991 to open generation to private sector and establishment of RLDCs.

· Amendment in 1998 to provide for private sector participation in transmission, and also provision relating to Transmission Utilities.

The Electricity Regulatory Commission Act, 1998

· Provision for setting up of Central / State Electricity Regulatory Commission with powers to determine tariffs.

· Constitution of SERC optional for States.

· Distancing of Government from tariff determination.

c) Electricity Act, 2003

This Act has repealed above three Acts namely (i) The Indian Electricity Act, 1910 (ii) The Electricity (Supply) Act, 1948 and (iii) The Electricity Regulatory Commission Act, 1998. The provisions of State Reforms Acts (list given at the end) have been saved under section 185 (3) of the Act subject to the condition that the provisions of the enactments are not in consistence with Electricity Act shall apply to the State in which such enactments are applicable.

7.6 Accounts of Electricity Companies under Indian Electricity Act

The Indian Electricity Act 1910 and Electricity (supply) Act 1948 contain provisions related financial statement in VI schedule. The main provisions are as follows:

1. Depreciation

The provision relating to the depreciation as given in Para VI of schedule VI can be summarised as follow:

i) Depreciation can be charged as per straight line method.

ii) The amount of depreciation under the straight line method is to be determined by dividing 90% of the cost by its effective life.

iii) No depreciation will be charged after 90% has been written off or when the assets ceases to be available for use due to obsolescence, inadequacy, superfluity or any other reasons.

iv) When a fixed asset is discarded, the written down value of the assets should be carried to a special account, termed as Discarded Assets Account.

2. Contingences Reserve

Every electricity company is required to maintain a contingency reserve. Reserve is created by transferring amount equal to not less than ¼ percent and not more than ½ percent of original cost of assets, from revenue account.

3. Development Reserve

The reserve is created by transfer of an amount equivalent to income –tax and super tax saved on account of development rebate allowed by the income tax authorities. If in an accounting year the clear profit excluding the special appropriations together with the accumulations, if any, in the tariff and dividend control reserve fall short of reasonable return, the appropriation to this reserve can be reduced by the amount of shortfall. The amount of such reserve is to be invested in the same electricity undertaking and is to be handed over to the purchaser of the business in case the business is sold away.

4. Tariff and Dividend

The reserve is created out of profits in excess of the reasonable return earned by an undertaking. This can be utilized whenever the clear profit is less than the reasonable return. The balance of reserve should be handed over to the purchaser in case the business is sold away.

5. General Reserve

According to section 67 of the Act, an electricity company should create a general reserve by making appropriation from revenue account after charging interest and depreciation. The amount to be appropriations from the revenue account should not exceed ½ per cent of the original cost of the fixed assets.

7.7 Prescribed Format of Final Accounts

The prescribed format of Final Accounts as per Indian Electricity Act 1910 is given below:

NET REVENUE ACCOUNT

For the year ending

Particulars	Rs.	Particulars	Rs.
To Interest of Debentures		By Balance from last account	
To contingence Res transfer		By Balance brought from revenue	
		By Interest	

Revenue Account

For the year ending-------

Particulars	Amount	Particulars	Amount
A. Generation		1. By sale of energy for lighting	
1. To Fuel		2. By sale of energy for power	
2. To salary of Er.		3. By Sale under sep contracts	
3. To wages		4. By Public Lighting	
4. To Repairs		5. By Rental of meters	
B. Distribution		6. By Rent receivable	
1. To salary		7. By Transfer Fees	
2. To Wages		8. By other items	
3. To Repairs		9. By Missc. Receipts	
C. Public Lamps		10. By sale of ashes	
1. To Attendance		11. By Reconstruction or Deconstruction	
2. To renewals			
D. Rent, Rate and Taxes			
1. To Rent Payable			

2. To Rate & Taxes

E. Management Expen
1. To Director Remmu.
2. To Gen Estb.
3. To Auditor of Co

F. Law Charges
1. To Law Charges

G. Depreciation
1. To lease
2. To Buildings
3. To Plant
4. To Mains
5. To Meters

Receipts and Expenditure on Capital Account

For the year ending------------

Expenditure	**Exp. Upto end of Pre. Year**	**During Year**	**Total Exp.**	**Receipts**	**Receipts upto end of Pre. Year**	**During Year**	**Total Receipts**
To Preliminary Exp to be specified				By ordinary shares of------			
To land including Law charges				By preference shares of---			
To Buildings				By debenture stock			
To Plant				By Mortgages and Bonds			
To Mains							
To service connection							

To transformer To Meters To General stores	By amt, received in anticipation of calls By other receipts
Total Expenditure	
To Balance of Capital A/c	
Total	**Total**

GENERAL BALANCE SHEET

Liabilities	Rs.	Assets	Rs
Capital Account		Capital a/c	
Sundry creditors		Stores in hand	
Net Revenue		Sundry Debtors	
Reserve Fund		Preliminary Exp	
Depreciation Fund		Securities as held	
Special time		Special Items	
		Cash at Bankers	
		Cash on Hand	
Total		**Total**	

The accounting treatment for the electricity companies can be better understood with the help of following examples.

Example: 1 The following balances are extracted are extracted from the books of M/s Flashlight Electric company Ltd.

Fixed Assets: Expenditure Up to 1 January, 2012

(a) Land and Buildings Rs. 10, 00,000 (b) Machinery Rs. 15, 00,000

Addition during the year- Machinery Rs 3, 50,000

Depreciation Fund: (a) Machinery Rs 3, 00,000 (b) Buildings Rs 1, 00,000

Authorised Capital Rs. 50, 00,000 divided into Equity Shares of Rs. 100 each.

Issued and fully paid up 20,000 equity shares of Rs 100 each (Including 2,500 equity shares issued during the year).

$7^{1/2}$ per cent Debentures Rs 10, 00,000 secured by a charge on fixed assets.

Sundry creditors Rs 2,50,000; Reserve Fund Rs 5,00,000; Reserve Fund Investment at cost Rs. 5,00,000; Market Value Rs 5,25,000.

Stock Rs 3, 02,500; Sundry Debtors Rs 4, 50,000; Cash at Bank Rs 2, 00,000;

Cash on Hand Rs 50,000, Profit and Loss A/c (Cr) Rs 2, 02,500.

You are required to prepare:

(i) (a) Capital A/c and (b) General Balance Sheet as at the same date under the Double Account system.

Solution

Flashlight Electric Co. Ltd
Receipt and Expenditure on Capital Account
As on 31 December 2012

Expenditure	Expenditure Upto 31 Dec. 2011 Rs	Expanded during the year Rs	Total Expenditure	Receipts	Receipt up to 31 December 93	During year	Total
Land & Buildings	10,00,000	----	10,00,000	17,500 Shares @ 100	17,50,000	---	-----
Machinery	15,00,000	3,50,000	18,50,000	2,500 Shares@100		2,50,000	20,00,0000
				71/2 % Debentures	10,00,000	----	10,00,000
Total	25,00,000	3,50,000	28,50,000	Total	27,50,000	2,50,000	30,00,000
Balance of Capital A/c	2,50,000			Balance of Capital A/c		1,00,000	
Total	**27,50,000**	**3,50,000**	**30,00,000**	**Total**	**27,50,000**	**3,50,000**	**30,00,000**

General Balance Sheet
as on 31 December, 2012

Liabilities	Rs	Assets	Rs
Total Amount Received as per Capital A/c	30,00,000		
Sundry Creditors	2,50,000	Total Capital Expenditure as per Capital A/c	28,50,000
Net Revenue A/c	2,02,500	Stores on Hand	3,02,500
Reserve Fund	5,00,000	Sundry debtors	4,50,000
Depreciation Fund	4,00,000	Securities	5,00,000
		Cash & Bank Balances	2,50,000
	43,52,500		43,52,500

Example-2

From the following particulars available in respect of 'Powerful Electric Supply company Ltd' as at 31st March, 2012, work out the

i) Capital Base

ii) Reasonable return

iii) Surplus, and given the calculation for disposal of surplus if any.

Fixed Assets Rs. 60, 00, 00,000

Accumulated Depreciation 20, 00, 00,000

Cost of License 1, 00, 00,000

Depreciation Reserve Fund Investment 20, 00, 00,000

Loan Advanced by the State Electricity Board (SEB) 5, 00, and 00,000

Debentures 10, 00, 00,000

Tariff and Dividends Control Reserve 3, 00, 00,000

Security Deposit Received from consumers 3, 00, 00,000

Monthly Average of the Month-end Balances of Stores, Materials , supplies, cash and Bank 3,00,00,000

Clear profit for the Year 6, 00, 00,000

Other Information

i) All statutory investments stand at the current figures since April 1, 1997 and earn a return of 10% p.a.

ii) The applicable Reserve Bank of India rate is 9%.

Solution

Powerful Electricity Supply Co. Ltd
CAPITAL COMPUTATION OF CAPITAL BASE

Particulars		**Rs**
Fixed Assets		60,00,00,000
Cost of License		1,00,00,000
Contingences Reserve Investments		2,00,00,000
Monthly Average of the month end balances		3,00,00,000
		66,00,00,000
Less: Accumulated Depreciation	20,00,00,000	
Loans Advanced by SEB	5,00,00,000	
Debenture	10,00,00,000	
Security Deposit	3,00,00,000	
Tariff and Dividend Control Reserve	3,00,00,000	41,00,00,000
		25,00,00,000

(ii) Computation of Reasonable Return

Yield on capital Base @ 11% on Rs 25, 00, 00,000	Rs 2, 75, 00,000
Interest on Depreciation Reserve Fund Investment	2, 00, 00,000
½ % on loan from SEB	2, 50,000
½ % on Debenture	5, 00,000
	4, 82, 50,000

(iii) Computation of Surplus

	Rs
Clear Profit	6, 10, 00,000
Less: Reasonable Return (as per above)	4, 82, 50,000
	1, 27, 50,000
20% Reasonable Return	96, 50,000

b) Disposal of Surplus

i) Excess over 20% of Reasonable return to be Certified to Customers Rebate Reserve (1,27,50,000- 96,50,000) Rs 31,00,000

ii) Balance of Rs 96,50,000 is to be disposed of as follows:

1/3 of the surplus not exceeding 5% of reasonable return at the disposal of the company	Rs. 32, 16,667
1/2 of balance to be credited to Tariffs and Dividend Control Reserve	32, 16,666.
1/2 of balance to be credited to customers' rebate reserve	32, 16,667
	96, 50,000

7.8 Advantages of Double Entry System

1. It is possible to keep a full record of dual aspect of each transaction.
2. Transactions are recorded in a scientific and systematic manner and thus the books of accounts provide the most reliable information for controlling the Organization efficiently and effectively.
3. Since the total debit under this system be equal to total Credit, arithmetical accuracy of the books can be tested by means of a trial balance.
4. An income and expenditure accounts can be prepared to know the excess income/ expenditure during a particular period and to know how such excess income/ expenditure has arisen.
5. The financial position of the organization can be readily ascertained by preparing a Balance Sheet.
6. Frauds are prevented, because alteration in accounts becomes difficult and discovery of irregularities is facilitated.

7.9 Criticism of Double Account System

1. Distortion of Actual Financial Position

Revenu**e** account does not show true value of income because interest paid and interest received both are excluded from it. Similarly balance does not show true financial positions because assets are shown on cost without adjustment for depreciation.

2. **Unnecessary Details**

Balance sheet and income statement prepared required some unnecessary detail in terms of annexure which are not easy understandable.

7.10 Replacement of Assets

The accounting entries in case of replacement of an asset, under single account system, are different from those under double account system. In case of single account system, if an asset is scrapped or sold and replaced by another assets, the old assets is completely written off from the books of account and the resultant profit or loss, is transferred to the profit and loss account. The amount paid for purchase of the new asset, is capitalised to the full extent. **Example-3** if an asset having a book value of Rs. 3,000 is discarded and sold for Rs. 1,000 and a new asset is purchased for Rs. 5000 for replacement of assets the following entries will be passed.

Journal Entries

Sr. No	**Particular**	**Rs**	**Rs**
1	Cash A/c	1000	
	Profit and Loss A/c	2000	
	To Old Assets A/c		3000
2.	New Asset A/C	5000	
	To Cash A/c		5000

In case of double account system the following process is followed in case of old asset is replaced by new one:

1. Original cost of asset to be replaced is not touched at all. It continues to appear even after replacement.

2. The present estimated cost of replacement is ascertained. The cost so estimated is reduced by sale of old material or value of material used in construction of new asset.

3. The difference between actual costs an estimated cost of the old asset in its original form is capitalized.

Example-4: The Hindustan Gas Company rebuilt and rebuilt and re-equipped part of their works at a cost of Rs. 5, 00,000. The part of the old works thus superseded cost Rs. 3, 00,000. The capacity of the new works is double the capacity of the old works Rs. 20,000 is realised by the sale of old materials and old materials worth Rs 10,000 are used in the construction of the new works and included in the total cost of Rs 5, 00,000 mentioned above. The costs of labour and material are 25% higher than when the old works were built.

Solution

Journal

Particulars	Dr (Rs)	Cr(Rs)
Replacement Account Dr	3,75,000	
New Works Account Dr	1,15,000	
To Bank		4,90,000
(Being the amount written off (Rs 3,00,000 + 25%) and the amount capitalized out of the Rs. 4,90,000, spend on reconstruction in cash)		
New Works A/c Dr	10,000	
To Replacement Account		10,000
(Being the materials used in the works)		
Bank	20,000	
To Replacement Account		20,000
(Being the amount realised by the sale of old materials)		
Revenue Account Dr	3,45,000	
To Replacement Account		3,45,000
(Being the transfer of balance of replacement account to revenue)		

Working Notes

Cost of Works Rs 3, 00,000

Add: Increase in cost $= \frac{3,00,000\ X\ 25}{100}$ 75,000

Current cost of old works 3, 75,000

Cash cost of new works= Rs 5, 00,000- 10,000= 4, 90,000

Account to be capitalised= Rs 4, 90,000- 3, 75,000= 1.15,000

7.11 Summary

Double account system is a system of presenting final accounts where a firm prepare two balance sheets instead of one. The form of presentation of final accounts of such enterprises is prescribed by the special Act under which companies registered. It relate to the preparation of balance sheet of such companies according to the pattern of double account system which is different from other companies. The Indian Electricity Act 1910 and Electricity (supply) Act 1948 contain provisions related financial statement in VI schedule. Double account system should not be confused with double entry system. Double entry is a method book keeping while double system is a method of presentation of final accounts. As a matter of fact fundamental principal of double entry shall be applicable in both double account and double entry system. It is the only way of presentation of final accounts which differentiate between these two terms.

7.12 Keywords

Capital Account: An account recording of receipts and expenditure under capital under double account System.

Contingency Reserve: A reserve created by an electricity company by transferring from original cost of the fixed assets till equal to 5% of the original cost of the fixed assets.

Development Reserve: A reserve created by transferring an amount equivalent to income tax and super tax saved on account of development rebate allowed by income tax authorities.

Double Account System: A system of presenting firm's final accounts where balance sheet is spilt up in two parts comprising a capital account and a general balance sheet.

General Balance Sheet: A statement containing assets and liabilities and the balance of capital account.

7.13 Review Questions

1. Explain the meaning of double account system. State how it differs from single account system.

2. Explain briefly the merits and demerits of maintaining final accounts using double account system.

3. Explain the salient features of double account system.

4. Differentiate between double account system and double entry system.

5. The following balances have been extracted, at the end of 1996, from the books of an Electricity company:

Particulars	Rs	Particulars	Rs
Share Capital	1,00,00,000	Consumers' Deposit	40,00,000
Reserve Fund (Invested Govt Securities)	60,00,000	Amount contributed by consumer towards Cost of Fixed Assets	2,00,000
Contingencies Reserve(Invested in Govt securities)	12,00,000	Intangible Assets	8,00,000
Loan from State Electricity Board	25,00,000	Tariff and Dividend Control Reserve	10,00,000
		Current Assets(monthly average)	15,00,000
12% Debentures	20,00,000		
Development Reserve	8,00,000		
Fixed Assets	2,50,000		
Depreciation Reserve on Fixed Assets	2,50,000		

6. The following balances relate to an electricity company and pertain to its accounts for the year ended 31st December 2007:

Share Capital	Rs. 1, 00, 00,000
Reserve Fund (Investment in 5% Government Securities at Par)	60, 00,000
Contingencies Reserve –invested in 6% State Government Loans	20, 00,000
11 % Debentures	8, 00,000
Loan from State Electricity Board	30, 00,000
Development Reserve	10, 00,000
Fixed Assets	2, 00, 00,000
Depreciation Reserve on Fixed Assets	80, 00,000
Consumer‘s Deposits	75, 00,000
Amount contributed by consumers towards fixed assets	2,00,000
Intangible Assets	5,00,000
Tariffs and Dividend Control Reserve	6,00,000
Current Assets Monthly Average	20,00,000

The company earned a post tax profit of Rs. 9 Lakh, 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%.

7. From the following information and details relating to the year ended 31st March 1995 and bearing in mind the provisions of the Electricity (Supply) Act 1948, indicate the disposal of Profits of X Electricity corporation Limited:

Net Profit before charging debenture interest	Rs. 35, 00,100
Fixed Assets	4, 20, 00,000

Depreciation written off on fixed assets	4, 20, 00,000
Consumer's Deposits	75, 00,000
Amounts contributed by consumers towards fixed assets	2, 00,000
Intangible Assets	5, 00,000
Tariff and dividend Control Reserve	600,000
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 provisions of electricity Act, assuming that Bank Rate during the year was 8%.

7.14 Further Readings

1. . Arula Nandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House, Delhi.
2. Ghosh T.P., **Accounting Standards and Corporate Accounting Practices**, Taxman, New Delhi.
3. Gupta R.L. and Radha Swamy M., **Advanced Accountancy**, Sultan Chand and Sons, New Delhi.
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5. Shukla M.C. & Grewal S., **Advanced Accounts,** S. Chand &Company Ltd, New Delhi.

Lesson-8

INDIAN ACCOUNTING STANDARDS –I

Dr. Sushil Kumar

8.0 Objectives

The objectives of the present chapter are:

1. To understand the concept of accounting standards;
2. to understand accounting standard related to inventories and
3. to understand the accounting treatment related to research and development.

8.1 Introduction

Accounting has been in existence ever since the dawn of civilization where a person in the settlement wanted to keep track of his belongings and ensure a legal claim on his holdings – be it land or farm animals. However, Fra Luca Bartolomeo de Pacioli (1445-1517) has been regarded as the father of modern accountancy for his noteworthy works describing the system of bookkeeping i.e. the double-entry accounting system which is widely accepted across the business world even today. As time passes, a natural development in accounting became evident. Industrial revolution and voluminous transactions in a complex financial and business environment led to need-based accounting, specific to the nature of transactions involved. The pressing demand for uniform accounting standards was felt in early 1930s post the Wall Street crash and the following great depression post the economic boom of 1920s. 'Accounting Standards' constitute the basic principles and procedures covering aspects of recognition, measurement, treatment and disclosure of accounting transactions in the financial statements. Conformity with accounting standards reduces or even eliminates the diverse practices and enhances comparability and comprehensibility of financial statements.

8.2 Meaning and Definitions

(a) AS issued by ICAI

Accounting Standards Board is established by Institute of Chartered Accountants of India (ICAI) for formulation of accounting Standards. As on date, there are only 32 Accounting Standards which have been issued by ICAI (of which AS 8 has been withdrawn). In general these Accounting Standards apply to enterprises engaged in commercial, industrial or business activities, irrespective of whether they are profit oriented or not. However, the date and extent of applicability of individual accounting standard is specified by further classification of these enterprises into three levels -Level I, Level II and Level III enterprises.

(b)AS as per Companies Act, 1956

In exercise of the powers conferred by Section 642(1) (a) of the Companies Act, 1956 read with Section 211(3C) and Section 210A of this Act, the GOI in consultation with National Advisory Committee on Accounting Standards (NACAS), has notified Companies (Accounting Standards) Rules, 2006. Accordingly the GOI has prescribed AS 1 to 7 and 9 to 29 as published by the ICAI. Although a small and medium sized company as definition given in the Rules is eligible for exemption or relaxation until the company remains an SMC for two consecutive accounting periods.

(b) Accounting standard as per Income Tax Act, 1961

The Central Board Of Direct Tax (CBDT) has notified two accounting standards vide notification dated 25.1.1996 in terms of the provisions under section 145(2) of the Income Tax Act - Accounting standard I relating to Disclosure of Accounting Policies and Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies. These Accounting Standards are to be followed by all assesses following the mercantile/accrual system of accounting. In general, the mandatory Accounting Standards(as issued by ICAI) are applicable to financial statements and other financial reporting which are statutorily required to be audited under any law (including audit covered under Sec 44AB of Income Tax Act, 1961).

8.3 Prefaces to the Statements of Accounting Standards

The following is the brief of the Preface to the Statements of Accounting Standards (revised 2004), issued by the Council of the Institute of Chartered Accountants of India. With the issuance of this revised preamble, the preamble to the Statements of Accounting Standards, issued in January, 1979, stands outdated. Preface of accounting covers Formation of accounting standard board. The Institute of Chartered Accountants of India (ICAI), recognising the need to harmonise the diverse accounting policies and practices in use in India, constitute the accounting standards board (ASB) on 21st April, 1977. The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB, objectives and Functions of the Accounting Standards Board are; i) To conceive of and suggest areas in which Accounting Standards need to be developed. (ii) To prepare Accounting Standards with a view to assisting the Council of the ICAI in evolving and establishing Accounting Standards in India. (iii) To examine how outlying the related International

Accounting Standard/ International Financial Reporting Standard can be adapted while formulating the Accounting Standard and to adapt the same.

8.4 Valuation of Inventories (AS-2)

(a) Objective

A primary issue in accounting for inventories is the determination of the value at which inventories are carried in the financial statements until the related revenues are recognised. This Standard deals with the calculation of such value, including the ascertainment of cost of stock and any write-down thereof to net realisable value.

(b) Scope

1. This Standard should be applied in accounting for inventories other than:

(i) Work in progress arising under contracts of construction, including directly related service contracts (see Accounting Standard (AS) 7, Construction Contracts);

(ii) Work in progress arising in the ordinary course of business of service providers;

(iii) Shares, debentures and other financial instruments held as stock-in-trade; and

(iv) Producers' inventories of agricultural, livestock, and forest products, mineral oils and, ores and gases to the extent that they are measured at net realisable value in accordance with well established practices in those industries.

2. The inventories are measured at net realisable value at certain stages of production. This occurs, for instance, when agricultural products have been harvested or ores, mineral oils and gases have been extracted and sale is assured under a forward contract or a government guarantee, or when a homogenous marketplace exists and there is a negligible risk of inability to sell. These stock items are excluded from the scope of this Standard.

(c) Measurement of Inventories

Inventory should be valued at the lower of cost and net realisable value.

Cost of Inventories: The cost of inventories should 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

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), 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.

Costs of Conversion

The costs of conversion of inventories include costs directly related to the units of manufacture, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into completed goods. Fixed manufacturing overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and the cost of factory management and supervision. Variable manufacturing overheads are those indirect costs of production that vary directly, or nearly directly, with the degree of production, such as indirect materials. The allocation of fixed production overheads for the purpose of their inclusion in the costs of conversion is based on the normal capacity of the production facilities. Ordinary capacity is the production expected to be achieved on an average over a number of periods or seasons under normal situation, after consideration of the loss of capacity due to planned maintenance. The actual stage of production may be used if it approximates normal capacity. The amount of fixed manufacturing overheads allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high level of production, the amount of fixed manufacturing 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. A production process may result in more than one product being produced concurrently. This is the case, for instance, when joint products are produced or when there is a main product and a by-product. When the costs of renovation of each product are not separately identifiable, they are distributed between the products on a rational and consistent basis. The distribution may be based, for instance, on the comparative sales value of each product either at the stage in the production process when the products become individually identifiable, or at the finishing point of production. Most by-product as well as crumb or waste materials, by their character, are unimportant. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a consequence, the carrying amount of the main product is not materially different from its cost.

Other Costs

Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be suitable to include overheads other than production overheads or the costs of designing products for specific customers in the cost of inventories.

Interest charges and other costs of borrowing are usually considered as not relating to bringing the inventories to their present location and condition and are, therefore, usually not included in the cost of inventories.

Exclusions from the Cost of Inventories

In determining the cost of inventories , it is suitable 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 those costs are essential in the production process prior to a further production stage; (c) Administrative overheads that do not contribute to bringing the inventories to their present location and condition; and

(d) Selling and distribution costs.

Cost Formulas

The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects should be assigned by specific identification of their individual costs. Specific recognition of cost means that specific costs are attributed to identified items of inventory. This is a suitable treatment for items that are segregated for a specific project, regardless of whether they have been purchased or produced. Although, when there are numbers of items of inventory which is ordinarily interchangeable, specific classification of costs is unsuitable since, in such situations, an enterprise could obtain predetermined effects on the net profit or loss for the period by selecting

1. The cost of inventories, other than those dealt with in above paragraph should be assigned by using the first-in, first-out (FIFO), or weighted average cost formula. The formula used should replicate the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition.

2. A variety of cost formulas are used to determine the cost of inventories other than those for which specific identification of individual costs is suitable. The formula used in calculating the cost of an item of inventory needs to be selected with a view to providing the fairest possible

approximation to the cost incurred in bringing the item to its present location and condition. The FIFO formula assumes that the items of inventory which were purchased or produced first are consumed or sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the enterprise.

(d)Techniques for the Measurement of Cost

1. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate the actual cost. Standard costs take into account normal levels of consumption of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

2. The retail method is often used in the retail trade for measuring inventories of large numbers of rapidly changing items that have similar margins and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing from the sales value of the inventory the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. An average percentage for each retail department is often used.

3. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories

may also not be recoverable if the estimated costs of completion or the estimated costs necessary to make the sale have increased.

4. Inventories are usually written down to net realisable value on an item by- item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses and are produced and marketed in the same geographical area and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write down inventories based on a classification of inventory, for example, finished goods, or all the inventories in a particular business segment.

5. 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.

6. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess inventory is based on general selling prices. Contingent losses on firm sales contracts in excess of inventory quantities held and contingent losses on firm purchase contracts are dealt with in accordance with the principles enunciated in Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected

to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realisable amount, the materials are written down to net realisable amount. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

7. An assessment is made of net realisable value as at each balance sheet date.

(e) Disclosure

The financial accounts should disclose:

(a) The accounting policies adopted in calculating inventories, including the cost formula used; and

(b) The total carrying charges of inventories and its classification appropriate to the enterprise.

Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of stock are raw materials and components, W.I.P. completed goods, stores and spares.

8.5 Depreciation Accounting (AS-6)

(a)Scope: This Standard deals with depreciation accounting and applies to all depreciable possessions, apart from the following items to which special considerations apply:—

(i) Forests, plantations and similar regenerative natural resources;

(ii) Wasting assets including expenditure on the exploration for and mining of minerals, oils, natural gas and similar non-regenerative resources;

(iii) Overheads on research and development;

(iv) Goodwill and other intangible assets;

(v) Livestock.

This standard also does not apply to land unless it has a limited useful life for the enterprise. Different accounting policies for depreciation are adopted by different enterprises. Exposure of accounting policies for depreciation followed by a venture is necessary to appreciate the view presented in the financial statements of the enterprise.

(b) Definitions

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

1. Depreciation is a measure of the wearing out, utilization or other loss of value of a depreciable asset arise from utilize, effluxion of time or obsolescence through technology and marketplace changes. Depreciation is owed so as to charge a fair proportion of the depreciable amount in each accounting period during the expected useful life of the asset. Depreciation also covered the term amortisation of assets whose useful life is predetermined.

2. Depreciable assets are assets which (i) are expected to be used during more than one accounting period; and (ii) have a limited useful life; and (iii) 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.

3. Useful life is either (i) the period over which a depreciable asset is expected to be used by the enterprise; or (ii) the number of production or similar units expected to be obtained from the use of the asset by the enterprise.

4. Depreciable sum of a depreciable possession is its historical cost, or other amount substituted for historical cost1 in the financial statements, less the estimated residual value.

Explanation

1. Depreciation has a significant effect in determining and presenting the financial position and results of operations of a venture. Depreciation is charged in every accounting period by reference

to the extent of the depreciable sum, without any consideration to an increase in the market value of the assets. Assessment of depreciation and the amount to be charged in respect thereof in an accounting period are usually based on the following three factors:

(i) Historical cost or other sum substituted for the historical cost of the depreciable asset when the asset has been revalued;

(ii) Expected functional life of the depreciable asset; and

(iii) Estimated residual value of the depreciable asset.

2. Historical cost of a depreciable asset represents its money outlay or its equivalent in connection with its acquisition, installation and commissioning as well as for additions to or improvement thereof. The historical cost of a depreciable asset may undergo subsequent changes arising as a result of increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors.

3. The useful life of a depreciable asset is shorter than its physical life and is:

(i) Pre-determined by legal or contractual limits, such as the expiry dates of related leases;

(ii) Directly governed by extraction or consumption;

(iii) Dependent on the extent of use and physical deterioration on account of wear and tear which again depends on operational factors, such as, the number of shifts for which the asset is to be used, repair and maintenance policy of the enterprise etc.; and

(iv) Reduced by obsolescence arising from such factors as:

(a) Technological changes;

(b) Improvement in production methods;

(c) Change in market demand for the product or service output of the asset; or

(d) Legal or other restrictions.

4. Determination of the useful life of a depreciable asset is a matter of estimation and is normally based on various factors including experience with similar types of assets. Such estimation is more difficult for an asset using new technology or used in the production of a new product or in the provision of a new service but is nevertheless required on some reasonable basis.

5. Any addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is depreciated over the remaining useful life of that asset. As a practical measure, however, depreciation is sometimes provided on such addition or extension at the rate which is applied to an existing asset. Any addition or extension which retains a separate identity and is capable of being used after the existing asset is disposed of, is depreciated independently on the basis of an estimate of its own useful life.

6. Determination of residual value of an asset is normally a difficult matter. If such value is considered as insignificant, it is normally regarded as nil. On the contrary, if the residual value is likely to be significant, it is estimated at the time of acquisition/installation, or at the time of subsequent revaluation of the asset. One of the bases for determining the residual value would be the realisable value of similar assets which have reached the end of their useful lives and have operated under conditions similar to those in which the asset will be used.

7. The quantum of depreciation to be provided in an accounting period involves the exercise of judgement by management in the light of technical, commercial, accounting and legal requirements and accordingly may need periodical review. If it is considered that the original estimate of useful life of an asset requires any revision, the unamortised depreciable amount of the asset is charged to revenue over the revised remaining useful life.

8. There are several methods of allocating depreciation over the useful life of the assets. Those most commonly employed in industrial and commercial enterprises are the straight line method

and the reducing balance method. The management of a business selects the most appropriate method(s) based on various important factors e.g., (i) type of asset, (ii) the nature of the use of such asset and (iii) circumstances prevailing in the business. A combination of more than one method is sometimes used. In respect of depreciable assets which do not have material value, depreciation is often allocated fully in the accounting period in which they are acquired.

9. The statute governing an enterprise may provide the basis for computation of the depreciation. For example, the Companies Act, 1956 lays down the rates of depreciation in respect of various assets. Where the management's estimate of the useful life of an asset of the enterprise is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate.

10. Where depreciable assets are disposed of, discarded, demolished or destroyed, the net surplus or deficiency, if material, is disclosed separately.

11. The method of depreciation is applied consistently to provide comparability of the results of the operations of the enterprise from period to period. A change from one method of providing depreciation to another is made only if the adoption of the new method 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. When such a change in the method of depreciation is made, depreciation is recalculated in accordance with the new method from the date of the asset coming into use. The deficiency or surplus arising from retrospective recompilations of depreciation in accordance with the new method is 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 is charged in the statement of profit and loss. In case the change in the method results in surplus, the surplus

is credited to the statement of profit and loss. Such a change is treated as a change in accounting policy and its effect is quantified and disclosed.

12. Where the historical cost of an asset has undergone a change due to circumstances specified in para 6 above, the depreciation on the revised unamortised depreciable amount is provided prospectively over the residual useful life of the asset.

(c) Disclosure

1. The depreciation methods used, the total depreciation for the period for each class of assets, the gross amount of each class of depreciable assets and the related accumulated depreciation are disclosed in the financial statements along with the disclosure of other accounting policies. The depreciation rates or the useful lives of the assets are disclosed only if they are different from the principal rates specified in the statute governing the enterprise.

2. In case the depreciable assets are revalued, the provision for depreciation is based on the revalued amount on the estimate of the remaining useful life of such assets. In case the revaluation has a material effect on the amount of depreciation, the same is disclosed separately in the year in which revaluation is carried out.

3. A change in the method of depreciation is treated as a change in an accounting policy and is disclosed accordingly.

Main Principles

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.

1. 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 is

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.

2. The useful life of a depreciable asset should be estimated after considering the following factors:

(i) expected physical wear and tear;

(ii) obsolescence;

(iii) legal or other limits on the use of the asset

3. 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.

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

5. Where the historical cost of a depreciable asset has undergone a change due to increase or decrease in long term liability on account of exchange fluctuations, price adjustments, changes in duties or similar factors, the depreciation on the revised unamortised depreciable amount should be provided prospectively over the residual useful life of the asset.

6. Where the depreciable assets are revalued, the provision for depreciation should be based on the evalued 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.

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

8. The following information should be disclosed in the financial statements:

(i) the historical cost or other amount substituted for historical cost of each class of depreciable assets;

(ii) total depreciation for the period for each class of assets; and

(iii) the related accumulated depreciation.

9. The following information should also be disclosed in the financial statements along with the disclosure of other accounting policies:

(i) depreciation methods used; and

(ii) depreciation rates or the useful lives of the assets, if they are different from the principal rates specified in the statute governing the enterprise.

8.6 Accounting for Construction Contract (AS-7)

(a) Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different accounting periods.

(b) Scope: This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

(c) Definitions: The following items are used in this Standard with the meanings specified:

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

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

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

Explanation

1. **Cost of Research and Development**

1.1 There can be practical difficulties in deciding the amounts of the costs specifically attributable to research and development. In order to achieve a reasonable degree of comparability between enterprises and between accounting periods of the same enterprise, it is necessary to identify the elements comprising research and development costs.

1.2 Costs incurred for research and development include the following:

(i) salaries, wages and other related costs of personnel;

(ii) costs of materials and services consumed;

(iii) depreciation of building, equipment and facilities which have alternative economic use, to the extent that they are used for research and development;

(iv) an appropriate amortisation of the cost of building, equipment and facilities which have no alternative economic use, to the extent that they are used for research and development;

(v) a reasonable allocation of overhead costs;

(vi) payment to outside bodies for research and development projects related to the enterprise; and

(vii) other costs, such as the amortisation of patents and licences.

1.3 Costs incurred to maintain production or to promote sales of existing products are excluded from the costs of research and development. Thus, the costs of routine or periodic minor modifications to existing products, production lines, manufacturing processes and other ongoing operations as well as routine or promotional costs of market research are excluded.

2. Accounting Treatment of Research and Development Costs

2.1 The allocation of the costs of research and development activities to accounting periods is determined by their relationship to the expected future benefits to be derived from these activities. In most cases there is little, if any, direct relationship between the amount of current research and development costs and future benefits because the amount of such benefits, and the periods over which they will be received, are usually too uncertain. Research and development costs are therefore usually charged to expense in the period in which they are incurred.

2.2 If it can be demonstrated, however, that the product or process is technically and commercially feasible and that the enterprise has adequate resources to enable the product or process to be marketed, it may be appropriate to defer the costs of related research and development to future periods. Research and development costs previously written off are not reinstated because they were incurred at a time when the technical and commercial feasibility of the project was too uncertain to establish a relationship with future benefits and they were therefore proper charges to those past periods.

2.3 Deferred research and development costs are amortised on a systematic basis, either by reference to the sale or use of the product or process or by reference to a reasonable time period. However, technological and economic obsolescence create uncertainties that restrict the number of units and time period over which deferred costs are to be amortised.

2.4 Wherever research and development costs are to be deferred, the appropriate legal requirements are also taken into account, for example, in the case of companies the need to provide depreciation on fixed assets used for purposes of research and development in accordance with the provisions of Sections 205 and 350 of the Companies Act.

3. Disclosure

3.1 The accounting policy adopted for the costs of research and development is included in the statement of accounting policies (see AS 1 on 'Disclosure of Accounting Policies'). Information about amortisation a practice is also disclosed when research and development costs are deferred.

3.2 The disclosure of

(i) research and development costs, including the amortisation of deferred costs, charged as an expense of each period, and

(ii) the unamortised balance, if any, of deferred research and development costs,

enables the users of financial statements to consider the significance of such activities in relation to those of other enterprises as well as to the other activities of the enterprise itself.

(d) **Combining and Segmenting Construction Contracts**

The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts. When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:(a) separate proposals have been submitted for each asset; (b) 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 (c) the costs and revenues of each asset can be identified.

(e) Contract Revenue: Contract revenue should comprise: (a) the initial amount of revenue agreed in the contract; and (b) variations in contract work, claims and incentive payments: (i) to the extent that it is probable that they will result in revenue; and (ii) they are capable of being reliably measured.

(f) Contract Costs: Contract costs should comprise: (a) costs that relate directly to the specific contract; (b) costs that are attributable to contract activity in general and can be allocated to the contract; and (c) such other costs as are specifically chargeable to the customer under the terms of the contract.

(g) Disclosure: An enterprise should disclose: (a) the amount of contract revenue recognised as revenue in the period; (b) the methods used to determine the contract revenue recognised in the period; and (c) the methods used to determine the stage of completion of contracts in progress.

8.7 Accounting for Research and Development (AS-8)

(a) Scope: This Statement deals with the treatment of costs of research and development in financial statements.

The Statement does not deal with the accounting implications of the following specialised activities:

(i) Research and development activities conducted for others under a contract;

ii) Exploration for oil, gas and mineral deposits;

(iii) Research and development activities of enterprises at the construction stage.

(b) Definitions

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

(i) Research is original and planned investigation undertaken with the hope of gaining new scientific or technical knowledge and understanding;

(ii) Development is the translation of research findings or other knowledge into 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.

(c) Cost of Research and Development: Costs incurred for research and development include the following: (i) salaries, wages and other related costs of personnel; (ii) costs of materials and services consumed; (iii) depreciation of building, equipment and facilities which have alternative economic use, to the extent that they are used for research and development; (iv) an appropriate amortisation of the cost of building, equipment and facilities which have no alternative economic use, to the extent that they are used for research and development; (v) a reasonable allocation of overhead costs; (vi) payment to outside bodies for research and development projects related to the enterprise; and (vii) other costs, such as the amortisation of patents and licences.

(d) Disclosure: The total of research and development costs, including the amortised portion of deferred costs, charged as expense should be disclosed in the profit and loss account for the period. Deferred research and development expenditure should be separately disclosed in the balance sheet under the head 'Miscellaneous Expenditure'.

8.8 Summary

Accounting has been in existence ever since the dawn of civilization where a person in the settlement wanted to keep track of his belongings and ensure a legal claim on his holdings – be it land or livestock. Accounting Standards Board was established by Institute of Chartered Accountants of India (ICAI) for formulation of accounting Standards. As on date, there are 32 Accounting Standards which have been issued by ICAI (of which AS 8 has been withdrawn). In general these Accounting Standards apply to enterprises engaged in commercial, industrial or business activities, irrespective of whether they are profit oriented or not. However, the date and extent of applicability of individual accounting standard is specified by further classification of these enterprises into three categories-Level I, Level II and Level III enterprises. The Institute of Chartered Accountants of India (ICAI), recognising the need to harmonise the diverse accounting policies and practices in use in India, constituted the Accounting Standards Board (ASB) on 21stApril, 1977. The composition of the ASB is fairly broad-based and ensures participation of all interest-groups in the standard-setting process. Apart from the elected members of the Council of the ICAI nominated on the ASB.

8.9 Keywords

Contract Revenue: Contract revenue should comprise: (a) the initial amount of revenue agreed in the contract; and (b) variations in contract work, claims and incentive payments: (i) to the extent that it is probable that they will result in revenue; and (ii) they are capable of being reliably measured.

Cost of Inventories: The cost of stock items should 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: 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), freight inside and other expenditure directly related to the acquisition. Rebates, drawbacks of duty, Trade discounts and other similar items are deducted in determining the costs of purchase.

Depreciation is a measure of the wearing out, utilization or other loss of value of a depreciable asset arising from use, effluxion of time or obsolescence through technology and market changes.

8.10 Review Questions

Q.1. Define the term accounting standard. Explain Accounting Standard-2 in detail.

Q.2. Define the term Depreciation. Explain various accounting treatment of depreciation as per Indian Accounting standard**.**

Q. 3. Define the term Research and Development. Explain the accounting treatment regarding Research and Development as per Indian Accounting Standard.

Q. 4. Write a short note on:

(i) Cost of inventory

(ii) Cost of contract

(iii) Revenue of contract

8.11 Further Readings

1. Ghosh T.P., Allied, **Accounting Standards and Corporate Accounting Practices**, Taxman.

2. Gupta R.L. and Radhaswamy M., **Advanced Accountancy**– Sultan Chand & Sons, New Delhi

3. Shukla M.C. & Grewal S, **“Advanced Accounts” S.** Chand & Company Ltd, New Delhi.

4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency- Calcutta 700009

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CHAPTER-9

ACCOUNTING FOR AGRICULTURE FARMS AND HOTELS

9.0 Objective

After the study of present chapter the students will be able to:

1. understand the concept of agriculture farm;
2. understand the accounting process of agriculture farm and
3. explain key terms used in farm accounting

9.1 Introduction

In spite of its relative importance in the economy of many countries and its growing interrelationships with other sectors, agriculture has traditionally not received much attention from accounting researchers, practitioners and standard setters. Consequently, current accounting principles typically do not respond very well to the particular characteristics of agricultural business and the information needs of farmers and their stakeholders. As an example, so far there is no standard for biological assets, whose valuation is difficult and controversial. Together with other reasons, like the generally lower level of managerial sophistication and fewer economic means in the sector, the limited appropriateness of general accounting principles has led to a situation in which farmers are more reluctant to prepare accounting reports and use this kind of information than the agents in other economic sectors. On the other hand, it is generally believed that accounting can improve farm management and lead to better farm performance. It is also stated that farmers who used a formal record system over time improved their ability to use the kind of information the system produced.

9.2 Meaning and Definition

Farm accounting is measuring and recording in a systematic way all farm resources and all business transactions having financial consequences

9.3 Importance of Farm Accounting

As accounting involves much time and effort on the part of the farmer, there must be good reasons for keeping farm accounts. These reasons are the following (in decreasing order of importance):

1 Measurement of Income

First of all, it permits the farmer to find out the size of the income which is derived from the farm. Family expenses and other expenditures such as loan repayments and taxes may then be adjusted to that income. Money may be saved for investments in order to improve the farm.

2. Calculation of Real Value of Farm

To know the total value of the farm business and to know which part is actually owned by the farmer and which by others. This information is required for making a budget and for determining the creditability of the farm business and its real sales value.

3. Indispensable Tool for Farm Management

Farm accounts provide the indispensable tool for farm management. In other words, accounting is needed to obtain and to maintain the most profitable use of farm resources. Keeping farm accounts is the only way to reveal the weak spots in the farm's business and show where and how to improve management so as to arrive at a larger income. Note that accounts cannot by themselves teach a farmer how to farm, but they can without doubt assist the farmer to use agricultural knowledge to best advantage.

4 To detect loss or theft of cash or stock.

5 To provide the necessary data for a correct income tax assessment.

6 To claim expenses for work done by others.

Normally farmers dislike paper work, busy as they are with their farm work and where to keep records may be a real problem for a farmer, as one cannot expect that an office or a desk is available on the average farm. Therefore farm accounting should be kept very simple; it helps when all records can be kept in just one book. It would help too if, for instance, the Ministry of Agriculture would make a farm accounting book available for farmers. This would also guarantee uniformity in accounting practices. Such a farm accounting book should be set up in such a way that all data can be filled in directly. Farmers should be advised to fill in this book weekly or monthly at least. If a farmer keeps all receipts, invoices, statements and other business documents in a file, a box, or in a clip on the wall, he will have sufficient material to produce reliable accounting figures for the proper management of his farm.

9.4 Customary Business Documents and Their Use

(a) Cash Receipt

A cash sale takes place when merchandise is bought and paid for in cash. In this case the seller in a modern business will make out a cash receipt which is printed in duplicate. The original cash receipt is given to the buyer. The buyer should keep the receipt and later enter it in his Cash Book. The duplicate remains in the book of the seller; later on the seller will summarize the duplicates and enter them in his Cash Analysis Book. However, the (small scale) farmer selling at home or on the market is not likely to use a cash receipt book. He must note his sales (at the end of the day) in his petty cash book or directly in the Cash Book.

(b)Invoice

Whenever merchandise is sold on credit an invoice is made out in the invoice book which is usually in triplicate. The original invoice is given to the buyer together with the merchandise. Where monthly statements are sent to the buyer, the duplicates will be sent to the buyer together with the statement. The triplicate remains in the book as a record. Small scale farmers usually do not sell on credit. But they should keep the invoices which they receive in order to be able to check the statements.

(c) Statement

At the end of each month the seller can summarize all invoices to a customer in a statement; this statement is then sent to the customer for payment. The date of the statement is the last day of the month in question. The statement gives the dates of the invoices, their numbers with or without details and the amounts which are due, under the heading DEBIT. If during that month any payment or merchandise or credit is received from that customer, it will be accounted for under the heading CREDIT. The difference between debit and credit is entered under the heading BALANCE. This balance is the amount due for payment.

(d) Purchase Order

The purchase order is a written request to a trading business to supply specified merchandise on credit; at the same time it warrants payment when the merchandise (with the invoice) is delivered. A farmer will normally not make use of this purchase order, but in government departments, in companies and in large organisations it is an indispensable means of controlling expenditures. It is commonly called a ‘local purchase order’ or LPO (in English speaking countries). Officers in Ministries of such countries will certainly come across LPO's. A purchase order specifies the merchandise in number, kind, size, make, colour, etc. It needs the signature of the person who actually orders and that of the person who must approve the purchase.

(d) Cheque (check)

A cheque is an order to a bank to make a payment in money. A cheque is the safest and easiest way of paying a debt or a purchase for a person having a bank account. Two different bank accounts must be mentioned here: Current account and saving account.

(e) Money Order

A money order is another kind of order to make a payment. It is a means of transmitting money to persons who have no current bank account. It is provided by the Post Office or by a bank. To obtain a money order, the amount to be transmitted plus a fee have to be paid to the Post Office or the bank. A money order form has to be completed (sender, payee, name of the office where the money order can be cashed).

9.5 Balance Sheet

9.5.1 Measuring and recording of farm resources: The main purpose of farm management is to obtain and maintain the most profitable use of the available farm resources.

How profitably a farmer has used his or her resources are measured by Net Farm Income. Before we can calculate the Net Farm Income, we must first see how we can measure and record systematically the available farm resources. As in every business undertaking, the resources of a farm business are nature, labour and capital:

1. by ‘capital’ is commonly meant capital or production goods; not money.

2. ‘Labour’ is the resource provided by individual human beings with their free consent (it cannot be owned).

3. ‘Nature’ and ‘capital’ are either owned or rented.

When making a list of the resources, only those owned by the farmer are considered; the rented resources are taken into account when the cost of production are calculated. It is also important to know by what financial means the farmer is able to own his farm resources. The farm resources are also called ‘factors of production’. A general way of recording the facts about the available farm resources is the Balance Sheet (BS). The Balance Sheet is a listing of all the possessions and debts of the farm business at a certain date. The possessions are called ‘assets’ and normally listed on the right side of the Balance Sheet. The debts (= what is owed to others) are called ‘liabilities’; they are normally listed on the left side. Schematically a Balance Sheet looks as follows:

Balance sheet

of ----------------(name & place)		**On------------(date)**	
Liabilities	**credit**	**Assets**	**Debit**
How are the farm resources (possessions) financed:		Possessions = all farm resources	
a. by the farmer himself			
b. by others = loans or debts			

A Balance Sheet should always bear the name of the document (in this case Balance Sheet), the name and place of the business and the date.

The possessions or assets are listed in the following order: first the most fixed assets, such as land; then the more current assets; and finally the most liquid, such as cash in hand and money to be received. It is very important to separate property belonging to the farm business from property belonging to the farmer's household, both with respect to money and bank accounts, and to other properties. The total assets, also called Gross Capital, is the total value of all land, capital goods, stocks in store or in the field and money available in the business.

Under liabilities are listed the different sources used to finance the farm business. When the farmer is the sole supplier of finances the total assets (or Gross Capital) equal the Net Capital or Net Worth. The Net Capital is that part of the total value of the assets which is financed by the owner; it is therefore also called Capital Owned.

9.5.2 Depreciation

Depreciation means loss of value. Depreciation always refers to capital goods or investments. Depreciation is due to the fact that capital goods (or production goods) do not last forever but wears out. They deteriorate and finally become useless. Here we see a crucial difference between the biological world and the technical goods made by mankind. The (domestic) animals used in agriculture reproduce themselves even without human interference.

The technical goods go to pieces after a certain time and have to be replaced by new ones produced by industries. Not only wear and tear, but also age may cause depreciation. Something may become what is called obsolete, when it is outmoded. To calculate depreciation or loss of value, one should know how long a capital good is going to last. This will depend on its quality, the standard of maintenance and the way the capital good is handled. Hence, we do not quite know in advance how long a capital good is going to last. Therefore, to calculate depreciation we use averages based on the experience of others.

There are various methods of calculating depreciation. The most common method is the straight line method, in situations with no or little inflation (prices remain the same, or almost). This method is commonly used in farm accounting. The depreciation is calculated as if the value decreases by the same amount each year hence the name 'straight line method'.

9.5.3 Inventory and Valuation of Resources

Before a Balance Sheet can be drawn up a valuation and inventory of resources has to be made.

A valuation is the estimation of the value of each asset or item. An inventory is a list of all possessions or assets item by item, at their present value. In making valuations, the value of farm produce can be based either on its cost of production or on its market value. If possible, the cost of production is used; if this is not possible, the market value. We use the straight line method of depreciation and deduct depreciation from the value at the time of purchase or from the replacement value.

Rules of Valuation

a) **Land** does not deteriorate under good husbandry practices and keeps the same value; it may even become (much) more valuable with time. The value entered is the purchase price or the estimated price, based on the value of similar land in the area at the time

b) **Buildings** of stone or brick may last 25 to 40 years. So, depreciation is between 4% and 2.5% per year. Wooden buildings depreciate at about 10% per year.

c) **Machinery:** (A) non motorised machinery, for instance ploughs, harrows and carts, depreciate at about 10% per year; (B) motorised machinery, for instance tractors, harvesters and (diesel) pumps depreciate at 20% per year or more, depending primarily on maintenance and secondly on the number of hours which they operate per year.

d) **Small Tools** such as hammers, pliers, shovels, buckets, etc., which have purchase values of less than Rs 50 each, are often written off immediately at purchase (which means that their depreciation is 100%). However, on a large, modern farm there may be thousands of M worth of such small tools; some might be new and some nearly worn out. Therefore a suitable method is to calculate the new value of all small tools and to enter them on the Balance Sheet for half that value once and for all.

e) **Livestock** during an initial period the value of newly born farm animals increases; then the value remains constant and finally it decreases: in this period the animals are usually sold. Calculation of the depreciation of domestic animals is therefore meaningless. Something different is needed here. Livestock is listed by kind, age and sex. For example, in a dairy herd there are bulls, dairy cows, heifers over 2 years, heifers of 1 2 years and calves under 1 year. Each group of animals is valued by multiplying the number in that group by a fixed price. Ideally, this fixed price would be the cost of breeding a representative animal of that group. In certain countries a 'standard value' may be applied for inventory/valuation purposes. In other countries good averages may be available. If these are not available, the regional market prices or estimated cost prices have to be used. Purchased mature cattle are valued at the purchase price.

9.6 Cash Analysis Book

9.6.1 Cash Book/ Petty Cash and Diary

A. cash book is what it says, namely a record of all changes in cash and a record of all cash transactions. In other words, it records cash receipts and expenditures (or expenses). For farms with a bank account the cash book also records changes in the bank account since a bank account may be considered as an extension of the cash box at home. A cash book has separate columns for receipts and for expenditures. In addition there is a column for the date and one for a (brief) description of each transaction. So, the cash book in its simplest form is as follows:

Date	Description	Receipts (debit)	Expenditure (credit)

Each transaction starts with a new line in the cash book. To check whether the amount of money in the cash box (or purse) is equal to the cash balance in the cash book, the total expenditure in the cash book must be subtracted from the total receipts. In principle, the total cash receipts must be a larger sum than the total cash expenditures. But where a cash book also records bank account changes, the total receipts may be less than the total expenditure because a bank account can be overdrawn. To keep the cash book neat and tidy the above calculation is done in draft. Then the difference, which is called cash balance is entered in the expenditure column because, in accounting, debits and credits must always be equal. This procedure is called ‘closing the books’.

If there is a difference between the cash balance and the actual cash in hand, the farmer will usually be able to discover the error (by checking all entries) provided that the previous closing of the books did not take place too long ago. Therefore checking should be done weekly, or at least monthly. The ‘opening’ is done by entering the previous cash balance from the expenditures column in the receipts column and then calling it ‘cash in hand’.

B. Diary is a book of events, transactions or observations recorded daily or at frequent intervals. Large farms which keep a complete set of accounting books may use a diary for non financial records, such as work performed by labourers, fertilizer applications on specified crops and fields, dates of sowing and harvesting, servicing, yields, feed given to animals, etc.

9.6.2 The Design and Use of the Cash Analysis Book

It is not possible to calculate the Net Farm Income from the cash book as such. To make this possible, receipts and expenditures have to be sorted out, kind by kind. And, what is more, for management purposes the farmer needs to know more than the total receipts and expenditure which the (simple) cash book can provide. To be able to manage the farm in such a way that the most profitable use is made of the farm resources, the farmer must:-

a) Distinguish:(a) receipts for farm produce from other receipts, such as sales of capital goods and loans; and (b) expenditure for production purposes from expenditure for other purposes, such as investments and repayments;

b) Calculate the costs and revenues of his separate farming activities (also called enterprises);

c) Compare the output and costs of each activity with the results of previous years and also with the results of other farms.

9.6.3 Use of the Cash Analysis Book

The Cash Analysis Book: The Cash Analysis Book is an extension of the cash book. In order to analyze receipts and expenditure, the Cash Analysis Book adds several columns to the total receipts and total expenditures columns of the cash book.

In these columns receipts and expenditures of one and the same kind are recorded a second time. The totals of such columns enable a farmer at the end of the year to analyze each particular farm activity (or enterprise).

The number of these added columns depends on the number of activities (operations, enterprises) on the farm, and also on how many details the farmer requires about costs. So, the first three columns in a Cash Analysis Book are like those in a cash book: date, brief description, total. Then follow different types of columns, as required: columns in which the output and costs are entered for each activity (enterprise or operation) for which separate information is wanted; examples: maize, poultry, citrus, milk, cattle, woodlot; a column 'other output' on the receipts side and a column 'overhead costs' (or general costs) on the expenditure side, in which output and costs are entered which cannot be allocated to a specific activity; a column for livestock sales on the receipts side and a column for purchases on the expenditure side; a column for non output receipts and a column for non cost expenditures on the expenditure side. a column for receipts from the household (private) and a column for expenditure for the household; other columns**.**

It should be noted that all entries are made twice and on the same horizontal line: once in the total column and once in the appropriate analysis column. If a farmer has a business account with a bank, the same type of Cash Analysis Book can be used. Then, however, the columns of total receipts and total expenditure have to be divided into two: one cash and one bank. Moreover, an additional column is needed at the very end (after 'private') to enter all transfers from cash to bank and vice versa. This column could be called 'cross bookings'. All transfers have to be entered twice, once on the receipts and once on the expenditure side. This cross bookings column can then also be used for cash and bank balances at the opening and closing.

9.7 Profit and loss Account

9.7.1 Summary of a Year's Output and Costs

At the end of the year the columns of the Cash Analysis Book provide the totals of the receipts and expenditure of the business operations carried out in that year. This makes it possible to compile the Profit and Loss Account.

The Profit and Loss Account can be defined as: (a) a list of output and costs over a one year period; (b) in our case resulting in the Net Farm Income.

The origin of the name Profit and Loss Account is the industrial business company which came into being in the 19th century. In an industrial business company the head (the 'director') is usually an employee who is paid a salary. This salary is therefore an expenditure which is included in the costs of the Profit and Loss Account which finally shows a 'profit' or a 'loss'. A farm can be such an 'industrial company' with a salaried 'manager'. However, the legal status of a farming business is quite often that of a sole proprietor, a one man business or a family business. In our text we take the latter as being the case. The head of the farm is quite often both the owner and the 'entrepreneur' (see the 'farm as a commercial enterprise' text which describes the roles of the 'agricultural entrepreneur'). Therefore the reward (remuneration) for the labour and management provided by the head of the farm (or by family members) is not included in the expenditure, because it is not paid for with a salary or wages.

The remuneration then consists of what is left from the output after the costs have been deducted.

The balance is commonly called Net Farm Income (or Net Revenue or Net Return). Thus the Profit and Loss Account of a farm calculates the Net Farm Income. The Profit and Loss Account is divided into two parts. The left side shows the value of all output. It lists the headings of the Cash Analysis Book (receipts) and shows the total amount at the end of the year. The right side shows all costs. It lists the headings of the Cash Analysis Book (expenditures) and shows the total amount at the end of the year (note: right and left, do what is customary in your country). This seems simple enough. However, to obtain 'output' from 'receipts' and 'costs' from 'expenditures', some adjustments have to be made. In order to see this clearly it helps to keep in mind that:

Output = any produce from the farm

Cost = any sacrifice made in order to produce

9.7.2 Calculation of Profit and Loss Account from Cash Analysis Book

a. Adjustment for Output (or credits) Receivable

Farm produce that is sold on credit (for instance milk to National Co-operative Creameries NCC, grain to the Marketing Board) are not entered in the Cash Analysis Book until the date on which payment is received. This may be several months after delivery. Hence there will be 'debts receivable' at the beginning and at the end of the accounting year. Remember the 'debts receivable' on the Balance Sheet. As debts receivable at the beginning of the year concern output of the previous year, they have to be deducted from the total receipts in order to get the right output. But debts receivable at the end of the year concern output of the current year. Therefore they have to be added to the total receipts from the cash book, in order to get the real output of the current year.

b. Adjustment for Costs (or debts) Payable

Likewise, purchases on credit for the farm are not entered in the Cash Analysis Book until the actual payment is made. Therefore there will be debts payable at the start and at the end of the accounting year. As debts payable at the beginning of the year concern costs from the previous year, they have to be deducted from the total expenditure. Debts payable at the end of the year concern expenditure of the current year; therefore they have to be added to the total expenditure, in order to arrive at the correct costs for the year.

c. Adjustment for Stock

At the beginning and end of the year there are generally ‘dead stocks’ on the farm, which appear as Assets on the Balance Sheet. These stocks are either output or means of production (input). When a Profit and Loss Account is drawn up they have to be taken into account separately, as follows. Stock of output, such as grains and potatoes, present at the beginning of the year (produced during the previous year) and sold during the current year, must be entered as a receipt in the Cash Analysis Book. But, as it belongs to the previous year's output, it has to be deducted from this year's receipts. Stock of output present at the end of the year will not be entered in the Cash Analysis Book, but it is an output of this year. Therefore it must be added to this year's receipts. Examples of stock of input are feedstuffs, seeds, fertilizers and other agricultural chemicals. Stock of input present at the beginning of the year has been paid for in the previous year, but will be used in the production process during the current year. Therefore the value of this stock is a cost for the current year and has to be added to the expenditure. On the contrary, stock of input at the end of the year has been entered as expenditure in the Cash Analysis Book of the current year, but it will only be used the following year. As this is not a cost for the current year it has to be deducted from the expenditure.

d. The cost of capital, or the distinction between capital and current expenditure most purchases which are recorded as expenditure are used up within the current year of accounting. For instance, hired labour, seed, fertilizers, fuel and feed stuffs. Such current expenditure are simply costs. Other expenditure concern the purchase of capital goods or resources such as buildings, implements, machinery or livestock. They last longer than the current year. Such capital expenditure are not costs. The proper calculation of costs of capital goods requires further explanation.

In discussing the valuation of capital goods we have already come across the concept of depreciation. This must now be more closely studied. Capital goods (also called producer's goods, production goods or investments) are either ‘dead’ when produced by industries or live when produced biologically. The cost of dead capital must be considered separately from the cost of live capital or livestock. Dead stock, such as buildings, machinery and implements lose value by wear and tear. This loss of value or depreciation, which forms the cost of dead capital, is calculated as a percentage appropriate to each kind of dead capital, as we have seen before. Livestock or natural resources in general, do not depreciate as long as we do not make it deteriorate ourselves. Hence land will not depreciate as long as it is well managed and conserved. Young farm animals will replace old ones (which can be sold) and increase the herd's value. Therefore livestock (farm animals) is at the same time both capital good and farm produce. It therefore follows that all changes, caused either by growth, death, sale or purchase, have to be taken into consideration. We shall first consider the livestock changes regarded as produce, and then regarded as capital good:

1. As produce; when sales of livestock have been higher than purchases, there is a Net Sale. However, if more livestock is bought than sold, there is a Net Purchase, which is to be considered as a negative sale, or in a way as a cost of livestock.

2. As capital; when the value of livestock at the end of the year is higher than at the beginning (we learn this from the Balance Sheet) there is an increase in livestock, a capital gain which we call Growth of Livestock.

We must understand that this ‘growth of livestock’ is greatly affected by the sales or purchases of livestock during the year under consideration. The lower the Net Sales the bigger will be the Growth of Livestock, and vice versa. When the value of livestock at the end of the accounting year is lower than at the beginning, there is a decrease of livestock (a negative growth or a capital loss).This decrease of livestock will as a rule be caused by high Net Sales of Livestock. Hence in order to calculate the total output of livestock, it should be looked at simultaneously in two ways: as produce rendering net sales and as capital rendering growth.

Hence, the terms Net Sales and Growth of Livestock. Under good husbandry, Net Sales and Growth of Livestock will as a rule add up to a positive figure and appear on the output side of the Profit and Loss Account. Only if there are diseases and the like, will Net Sales and Growth of Livestock result in a negative figure and appear on the cost side of the Profit and Loss Account. It should now be clear that receipts from sales of capital are not output. They do not appear on the Profit and Loss Account but increase the cash on the Balance Sheet.

e. Repayment of Loan and Payment of Interest

One of the ways of increasing a farmer's income (which presupposes an increase in output) is to expand investments, or in other words to acquire more resources.

There are two ways of financing these investments: (1) either to use one's own savings or (2) to borrow money. It is usually more economical to use one's own savings but when there are no savings, the only way is to obtain a loan.

A loan is a means of financing investments which otherwise would have to be postponed.

Normally interest has to be paid. Interest can be considered as the price for the privilege of hiring money for one year. Therefore interest is a cost and should be entered in the Cash Analysis Book under the heading ‘overhead’, since a loan is considered as financing some part of the assets of the farm business.

A loan has to be repaid after a certain period. The repayment of a loan is not a cost but the acquisition of a resource. Therefore it is not recorded in the Profit and Loss Account. The repayment of a loan is recorded in the Cash Analysis Book in the column ‘other expenditures’. The balance of loans to be repaid is recorded as liability on the Balance Sheet.

When repaying a loan, the farmer is acquiring ownership of his resources. The repayment of a loan is actually included in the increase of the Net Capital and is paid out of the Net Farm Income. Therefore the repayment of a loan is also a way of saving. When a loan is received, its amount must be recorded in the Cash Analysis Book in the ‘other receipts’ column. When capital goods are acquired with this loan the procedure explained above must be followed.

f. Payments in Kind and Home Consumption

Some farmers pay part of the wages of their labourers in farm such as milk. This part of the wages does not appear in the Cash Analysis Book as expenditure. Therefore these payments in kind have to be calculated as non cash costs of labour. When these payments in kind have been produced on the farm, they must also be counted as non cash output. The farm produce consumed by the farmer's family is also a farm output which is not recorded in the Cash Analysis Book under crops or livestock because no money was involved. So, home consumption has to be estimated at the end of the year and must be entered as a non cash output only; never as a cost because it is included in the Net Farm Income.

g. Private

In the Cash Analysis Book, private expenditures are recorded in a separate column ‘private’, because they are payments out of the farm cash box (or out of the farm bank account) but they are not costs. Private expenditures have to be considered as payments in advance from the Net Farm Income (that is only known at the end of the year) to enable the farmer's family to provide for its needs. In the same way private receipts are recorded in a separate column. Private receipts are monies that the farmer puts into the farm business but which he obtained from activities not connected with the farm; for instance, dividends from shares, wages from an off farm job, gifts and pensions. Hence they are not farm output. Thus private receipts and private expenditures are omitted from the Profit and Loss Account.

The balance is called Private Drawings.

h. Net Farm Income and Proving of the Accounts

Net Farm Income = Total (or Gross) Output — Total Real Costs

Net Farm Income is derived from the Profit and Loss Account. It is understandably the most important piece of information for the farmer. The Net Farm Income NFI is entered on the cost side of the Profit and Loss Account to make it balance. It will be clear that the NFI is recorded as a cost, because the NFI is in fact the payment (or remuneration) which the farmer and the working members of the family receive for their labour, management and own capital.

However, the NFI resulting from the Profit and Loss Account is not the same as the cash which the farmer receives from the farm business. The Net Farm Income is in fact composed of three parts:

1. Cash income

2. Non cash income

3. Savings or investments

The cash income consists of the money the farmer really received from the farm business; it is called.

Private Drawings

Private Drawings are actually a part of the payments in advance for the farmer's and his or her family's labour and management. Any private receipts, however, might be considered as savings from outside the farm business, which are put into the farm business; they must therefore be deducted from the private expenditures so that Private Drawings are obtained.

The non cash income consists of the farm produce consumed by the farmer's family for which no payments have been made. It is estimated at market price. It is called Home Consumption. A ‘subsistence farmer’ is getting the major part of his NFI by way of Home Consumption (he will not be aware of this technicality).

The savings are that part of the NFI which the farmer does not spend in his family household but which he keeps in the farm. These savings will cause an increase in the Net Capital during the accounting year. Therefore this part of the NFI equals the difference between the Net Capital at the end and at the beginning of the accounting year.

If the Net Capital at the end of the year is smaller than at the beginning, then the farmer has been Consuming part of his capital; the debts will have increased or the total assets will have decreased. Unavoidably the result will be a decline in the next year's output and income. The above information can also be used for Proving the Accounts since.

NFI = Net Private Drawings + Home Consumption + Increase of Net Capital

9.7.3 Drawing Up the Final Accounts

In order to show how to apply the rules of adjustment described above we will continue with Mr. Dinesh Redhu's farm. To this end we need two more pieces of information, namely the Opening Balance Sheet and what is called Additional Information.

Opening Balance Sheet

Dinesh Redhu's farm 1.1.2012

Liabilities	Rs	Assets	Rs.
Net Capital	39,972	Fixed assets:	
		land, 5 ha	12,500
		Buildings	2,500
Creditor: veterinaries	176	Current Assets	
		Tractor	12000
		Livestock	8000
		Crops in store and in field	3000
		Debtor: milk Dec. 2011	148
		Bank account	1500
		Cash in hand	500

Gross Capital	40,148	Gross Capital	40,148

Additional Information:

Home consumption Rs 2,215

Debtors on 31.12.2011 (Milk) 258

Creditors on 31.12.2011 (Cattle feed) 205

Valuations on 31.12.2011:

1. Livestock 10,200

2. Crops in store and field 3,550

Purchase Values and Depreciation Rates

Investment	Date bought	Purchase value	Rate of depreciation
Buildings	Jan.01	Rs.3000	16 2/3% (= 1/6)
Tractor	March 01	Rs. 15000	20%
Equipment			10%

Calculation of Adjustments

The information provided above enables us to calculate the adjustments from receipts to output and from expenditures to costs:

	Crops	Milk	Net Sales & Growth of Livestock	Cattle Costs
Cash Analysis Book	5,911	4,960	3,115	991
Bal.Sheet & Add.Inf.	+ 550	– 148	+ 2,200	– 176

		+ 258		+ 205
Profit and Loss Account	6,461	5,070	5,315	1,020

Profit and Loss Account

For the output side we simply use the totals from the Cash Analysis Book and, if necessary, the adjusted figures shown above. We also use the figure for Home Consumption from 'Additional Information'. For the costs side we apply the same routine. Next we calculate the depreciations. They are deducted from the values on the Opening Balance Sheet or they are deducted from the purchase values, if bought during the current year. This will lead us to the figures in the Closing Balance Sheet.

As follows:

Farm buildings	depreciation	500	value Closing BS	2,000
Tractor:	-----	3,000	----------------	9,000
livestock Equipment	-----------------	50	---------------------	450

Profit and loss Accounts

Dinesh Redhu's farm 1st of January to 31st December 2012			
Output	Rs.	Costs	Rs.
Crops	6,461	Crops	1,315
Milk	5,070	Cattle costs	1,020
Net Sales & Growth of Livestock	5,315	Overhead	4,837
Home consumption	2,215	Depreciation of:	
		farm buildings	500

		tractor	3,000
		livestock equipment	50
		Net Farm Income	8,339
Gross Output	19,061	Total Costs	19,061

Closing Balance Sheet

The basis for the Closing Balance Sheet is the Opening Balance Sheet.

Always start with the assets. Check with ‘other expenditures’ from the Cash Analysis Book to see if new resources were bought and with ‘other receipts’ to see if old resources were sold. In our example new equipment adding up to M 500 was bought for the livestock enterprise. The depreciation values have already been calculated. Information about debtors, creditors and valuations has already been provided. Thus the Closing Balance Sheet will be:

Closing Balance Sheet

Dinesh Redhu's farm on 31.12.2012			
Liabilities	Rs.	Assets	Rs.
Creditor: cattle feed	205	Fixed assets:	
Net Capital	38,281	land, 5 ha	12,500
		Farm buildings	2,000
		Current assets:	
		Tractor	9,000
		livestock equipment	450
		Livestock	10,200
		Crops in store and field	3,550

		Debtor: milk Dec. 2006	258
		Bank account	400
		Cash in hand	128
Gross Capital	38,486		38,486

Proving of the Accounts

Private Drawings	Rs 7,815
Home Consumption	2,215
Increase of Net Capital Rs 38,281 – Rs 39,972 =	–1,691
Net Farm Income	Rs 8,339

9.8 Summary

In spite of its relative importance in the economy of many countries and its growing interrelationships with other sectors, agriculture has traditionally not received much attention from accounting researchers, practitioners and standard setters. Consequently, current accounting principles typically do not respond very well to the particular characteristics of agricultural business and the information needs of farmers and their stakeholders. As an example, so far there is no standard for biological assets, whose valuation is difficult and controversial.

9.9 Keywords

Total Area of Farm: It comprises total farm hectares including crops, grass, rough grazing, buildings, woodlands, waste-land, roads, etc.

Utilisable Agricultural Area (UAA): The area of crops, grass and rough grazing, fallow and any un cropped land that could be returned to agricultural production.

Livestock Units: There are based on estimated energy requirements. Standard ratios are used for converting animals of different species and ages into Livestock Units with one unit usually representing a mature 'black and white' dairy cow.

Standard Person-Day: This represents 8 hours work by an adult worker under average conditions.

Landlord-Type Capital: This comprises land and buildings, including improvements to these.

9.10 Review Questions

1. Define the term farm accounting. Explain various provisions relating to accounting treatment in farm.

2. Write a short on:

(i) Uses of cash book analysis

(ii) Diary Book

9.11 Further Readings

1. Ghosh T.P., Allied **Accounting Standards and Corporate accounting practices**, Taxmann.
2. Gupta R.L. and Radhaswamy M., **Advanced Accountancy**– Sultan Chand sons, New Delhi.
3. Shukla M.C. & Grewal S, **"Advanced Accounts"** Chand & Company Ltd, New Delhi.
4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency- Calcutta.
5. Arulanandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing Delhi.

Lesson-10

INDIAN ACCOUNTING STANDARD –II

10.0 Objectives

The objectives of the present chapter are:

1. to understand concept of accounting standards
2. to understand accounting treatment of revenue
3. to understand accounting treatment of fixed assets

10.1 Introduction

The International Public Sector Accounting Standards Board (the IPSASB) of the International Federation of Accountants (IFAC) develops accounting standards for public sector entities referred to as International Public Sector Accounting Standards (IPSASs). The IPSASB recognizes the significant benefits of achieving consistent and comparable financial information across jurisdictions and it believes that the IPSASs will play a key role in enabling these benefits to be realized. The adoption of IPSASs by governments will improve both the quality and comparability of financial information reported by public sector entities around the world. IPSASs are being prepared for application by entities adopting the accrual basis of accounting and for application by entities adopting the cash basis of accounting.

The IPSASB recognizes the right of governments and national standard setters to establish guidelines and accounting standards for financial reporting. The IPSASB considers that this Standard is an important step forward in improving the consistency and comparability of financial reporting under the cash basis of accounting and encourages the adoption of this Standard.

Meaning and Definitions

(d) Accounting Standards as issued by ICAI

Accounting Standards Board established by Institute of Chartered Accountants of India (ICAI) for formulation of accounting Standards. As on date, there are only 32 Accounting Standards which have been issued by ICAI (of which AS 8 has been withdrawn). In general these Accounting Standards apply to enterprises engaged in commercial, industrial or business activities, irrespective of whether they are profit oriented or not. However the date and extent of applicability of individual accounting standard is specified by further classification of these enterprises into three levels -Level I, Level II and Level III enterprises.

(e) Accounting Standards as per Companies Act, 1956

In exercise of the powers conferred by Section 642(1) (a) of the Companies Act, 1956 read with Section 211(3C) and Section 210A of this Act, the GOI in consultation with National Advisory Committee on Accounting Standards (NACAS), has notified Companies(Accounting Standards) Rules, 2006. Accordingly the GOI has prescribed AS 1 to 7 and 9 to 29 as published by the ICAI. Although a Small and Medium Sized Company as definition given in the Rules is eligible for exemption or relaxation until the company remains an SMC for two consecutive accounting periods.

(c) Accounting Standards as per Income Tax Act, 1961

The Central Board Of Direct Tax (CBDT) has notified two accounting standards vide notification dated 25.1.1996 in terms of the provisions under section 145(2) of the Income Tax Act - Accounting standard I relating to Disclosure of Accounting Policies and Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies. These Accounting Standards are to be followed by all assesses following the mercantile/accrual system of accounting. In general, the mandatory Accounting Standards(as issued by ICAI) are applicable to financial statements and other financial reporting which are statutorily required to be audited under any law (including audit covered under Sec 44AB of Income Tax Act, 1961).

10.2 Revenue Recognition (AS-9)

(a) Scope

This Standard deals with the bases for recognition of revenue in the statement of profit and loss of a company. The Standard is related with the recognition of revenue arising in the course of the ordinary activities of the enterprise from

— The sale of goods,

— The rendering of services, and

— The use by others of enterprise resources yielding interest, royalties and dividends.

This Standard does not cover the following aspects of revenue recognition to which special considerations apply:

(i) Revenue earned from construction contracts;

(ii) Revenue arising from, lease agreements and hire-purchase;

(iii) Revenue earned from government grants and other similar subsidies;

(iv) Revenue of insurance companies earned from insurance contracts.

Samples of items not covered within the definition of "revenue" for the purpose of this Standard are:

(i) Realised gains resulting from the sale of, and unrealised profits resulting from the holding of, non-current assets e.g. increase in the value of fixed assets;

(ii) Unrealised holding gains resulting from the change in value of current assets, and the natural appreciation in herds and agricultural and forest products;

(iii) Realised or unrealised profits resulting from changes in foreign exchange rates and adjustments arising on the translation of foreign currency financial statements;

(iv) Realised profits resulting from the settlement of an obligation at less than its carrying amount;

(v) Unrealised gains resulting from the restatement of the carrying amount of an obligation

(b) Definitions

The following stipulations are used in this Standard as the meanings given below:

1**.** Revenue is the gross inflow of cash, debtors or other consideration earned in the course of the ordinary activities of an enterprise from the sale of goods, from services rendered, and from right of use given to others for use of enterprise resources yielding royalties, dividends and interest. 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 others. In an agency association, the revenue is the amount of commission and not the gross inflow of receivables, cash, or any other form of reward.

2. 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.

3. 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.

Explanation

Revenue recognition is mainly concerned with the timing of recognition of revenue in the statement of profit and loss of a company. The sum of revenue earned on a transaction is usually determined by agreement between the parties involved in the transaction. When doubts exist regarding the calculation of the amount, or its connected costs, these uncertainties may influence the timing of revenue.

Effect of Uncertainties on Revenue Recognition

1. Recognition of revenue requires that revenue is measurable and that at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.

2. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc., revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise revenue only when it is reasonably certain that the ultimate collection will be made. Where there is no uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.

3. 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.

4. 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.

5. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognised

Sale of Goods

1. 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 price. The transfer of title of goods, in general cases, results in or coincides with the transfer of significant where transfer of property in goods does not coincide with the transfer of significant risks and rewards of ownership. Revenue in such cases is recognised at the time of transfer of significant risks and rewards of ownership to the purchaser. Such cases may take place where delivery has been delayed through the fault of either the buyer or the seller and the goods are at the risk of the party at fault as regards any loss which might not have occurred but for such mistake. Further, occasionally the parties may agree that the risk will pass at a time different from the time when ownership passes.

2. At certain stages in some particular industries, such as when agricultural products have been harvested or mineral ores have been extracted, performance may be significantly complete prior to the execution of the transaction creating 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 default to sell, the goods concerned are often valued at net realisable value. Such transactions,

which is not a revenue as defined in this Standard, are every so often recognised in the statement of profit and loss and appropriately

Rendering of Services

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

(i) Proportionate completion method—Performance consists of the execution of more than one act. Revenue is documented proportionately by reference to the performance of each act. The revenue under this method would be calculated on the basis of value of contract, associated costs, number of acts or other suitable basis. For matter-of-fact, when services are provided by an indeterminate number of acts over a specific time period, revenue is calculated on a straight line basis over the specific period unless there is evidence that some other method better represents the pattern of performance.

(ii) Completed service contract method—Performance consists of the execution of a single act. Alternatively, services are performed in more than a single activity, and the services which are still 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 activities. The completed service 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

(c) Disclosure

In addition to the disclosures essential by Accounting Standard 1 on 'Disclosure of Accounting Policies' (AS 1), an enterprise should also disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

10.3 Accounting for Fixed Assets (AS-10)

(a) Scope

Financial statements disclose certain information relating to fixed assets. In many enterprises these assets are grouped into various categories, such as land, buildings, plant and machinery, vehicles, furniture and fittings, goodwill, patents, trademarks and designs. This standard deals with accounting for such fixed assets except as described in paragraphs 1 to 4 below.

1. This standard does not deal with the specialised aspects of accounting for fixed assets that arise under a comprehensive system reflecting the effects of changing prices but applies to financial statements prepared on historical cost basis.

2. This standard 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.

Expenditure on individual items of fixed assets used to develop or maintain the activities covered in (i) to (iv) above, but separable from those activities, are to be accounted for in accordance with this Standard.

3. This standard does not cover the allocation of the depreciable amount of fixed assets to future periods since this subject is dealt with in Accounting Standard 6 on 'Depreciation Accounting'.

4. This standard does not deal with the treatment of government grants and subsidies, and assets under leasing rights. It makes only a brief reference to the capitalisation of borrowing costs and to

assets acquired in an amalgamation or merger. These subjects require more extensive consideration than can be given within this Standard.

(b) Definitions

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

l. 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.

2. 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.

3 Gross book value of a fixed asset is its historical cost or other amount substituted for historical cost in the books of account or final accounts. If this sum is shown net of accumulated depreciation, it is called as net book value.

Identification of Fixed Assets

1. The definition in paragraph gives criteria determining whether items are to be classified as fixed assets. Judgement is required in applying the criteria to specific circumstances or specific types of enterprises. It may be appropriate to aggregate individually insignificant items, and to apply the criteria to the aggregate value. An enterprise may decide to expense an item which could otherwise have been included as fixed asset, because the amount of the expenditure is not material.

2. 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 and their use is expected to be irregular, 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.

3. In certain circumstances, the accounting for an item of fixed asset may be improved if the total expenditure thereon is allocated to its component parts, provided they are in practice separable, and estimates are made of the useful lives of these components. For example, rather than treat an aircraft and its engines as one unit, it may be better to treat the engines as a separate unit if it is likely that their useful life is shorter than that of the aircraft as a whole.

Components of Cost

1. 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. Examples of directly attributable costs are:

(i) site preparation;

(ii) initial delivery and handling costs;

(iii) installation cost, such as special foundations for plant; and

(iv) professional fees, for example fees of architects and engineers.

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.

2. Financing costs relating to deferred credits or to borrowed funds attributable to construction or acquisition of fixed assets for the period up to the completion of construction or acquisition of fixed assets are also sometimes included in the gross book value of the asset to which they relate. However, financing costs (including interest) on fixed assets purchased on a deferred credit basis

or on monies borrowed for construction or acquisition of fixed assets are not capitalised to the extent that such costs relate to periods after such assets are ready to be put to use.

3. Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset. However, in some circumstances, such expenses as are specifically attributable to construction of a project or to the acquisition of a fixed asset or bringing it to its working condition, may be included as part of the cost of the construction project or as a part of the cost of the fixed asset..

4. 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. However, the expenditure incurred after the plant has begun commercial production, i.e., production intended for sale or captive consumption, is not capitalised and is treated as revenue expenditure even though the contract may stipulate that the plant will not be finally taken over until after the satisfactory completion of the guarantee period.

5. 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. However, the expenditure incurred during this period is also sometimes treated as deferred revenue expenditure to be amortised over a period not exceeding 3 to 5 years after the commencement of commercial production

Non-monetary Consideration

1. 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. An alternative accounting

treatment that is sometimes used for an exchange of assets, particularly when the assets exchanged are similar, is to record the asset acquired at the net book value of the asset given up in each case an adjustment is made for any balancing receipt or payment of cash or other consideration.

2. 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.

Improvements and Repairs

1. Frequently, it is difficult to determine whether subsequent expenditure related to fixed asset represents improvements that ought to be added to the gross book value or repairs that ought to be charged to the profit and loss statement. Only 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.

2. The cost of an addition or extension to an existing asset which is of a capital nature and which becomes an integral part of the existing asset is usually added to its gross book value. Any addition or extension, which has a separate identity and is capable of being used after the existing asset is disposed of, is accounted for separately.

Retirements and Disposals

1. An item of fixed asset is eliminated from the financial statements on disposal.

2. 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

3. In historical cost financial statements, gains or losses arising on disposal are generally recognised in the profit and loss statement.

4. 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

Valuation of Fixed Assets in Special Cases

1. 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.

2. Where an enterprise owns fixed assets jointly with others (otherwise than as a partner in a firm), 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

3. Where several assets are purchased for a consolidated price, the consideration is apportioned to the various assets on a fair basis as determined by competent valuers.

(c) Main Principles

1. The items determined in accordance with the definition in paragraph 1 of this Standard should be included under fixed assets in financial statements.

2. The gross book value of a fixed asset should be either historical cost or a revaluation computed in accordance with this Standard.

3. The cost of a fixed asset should comprise its purchase price and any attributable cost of bringing the asset to its working condition for its intended use.

4. The cost of a self-constructed fixed asset should comprise those costs that relate directly to the specific asset and those that are attributable to the construction activity in general and can be allocated to the specific asset.

5. When a fixed asset is acquired in exchange or in part exchange for a new asset, the cost of the asset acquired should be recorded either at fair market value or at the net book value of the asset given as consideration, adjusted for any balancing payment or receipt of cash or other consideration. For this point fair market value may be determined by reference either to the asset given up or to the asset purchased, whichever is more clearly evident. Fixed asset purchased in exchange for equity shares or other securities in the enterprise should be recorded at, the fair market value of the securities issued, or its fair market value whichever is more clearly evident.

6. Material items retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.

7. Fixed asset should be eliminated from the financial statements on disposal or when no further benefit is expected from its use and disposal.

8. Losses arising from the retirement or gains or losses arising from disposal of fixed asset which is carried at cost should be recognised in the profit and loss statement.

9. When a fixed asset is revalued in financial statements, a whole class of assets should be revalued, or the choice of assets for revaluation should be made on a systematic basis. This basis should be disclosed.

10. When a fixed asset is revalued upwards, any accumulated depreciation shown at the date of the revaluation should not be credited to the profit and loss statement.

11. An increase in net book value arising on revaluation of fixed assets should be credited directly to owners' interests under the head of revaluation reserve, except that, to the extent that such increase is related to and not greater than a decrease arising on revaluation previously recorded as a charge to the profit and loss account, it may be credited to the P & L account. A decline in net book value arising on revaluation of fixed asset should be charged directly to the profit and loss statement except that to the extent that such a decrease is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently reversed or

12. On disposal of a previously revalued item of fixed asset, the difference between net sale proceeds and the net book value should be charged or credited to the profit and loss statement except that to the extent that such a loss is related to an increase which was previously recorded as a credit to revaluation reserve and which has not been subsequently utilised or reversed, it can be charged directly to that account.

13. Fixed assets acquired on hire purchase terms should be recorded at their cash value, which, if not readily available, should be calculated by assuming an appropriate rate of interest. They should

be shown in the balance sheet with an appropriate narration to indicate that the enterprise does not have full ownership thereof.

14. In the case of fixed assets owned by the enterprise jointly with others, the extent of the enterprise's share in such assets, and the proportion of the original cost, accumulated depreciation and written down value should be stated in the balance sheet. Alternatively, the pro rata cost of such jointly owned assets may be grouped together with similar fully owned assets with an appropriate disclosure thereof.

15. Where several fixed assets are purchased for a consolidated price, the consideration should be apportioned to the various assets on a fair basis as determined by competent valuers.

16. Subsequent expenditures related to an item of fixed asset should be added to its book value only if they increase the future benefits from the existing asset beyond its previously assessed standard of performance.

17. The revaluation in financial statements of a class of assets should not result in the net book value of that class being greater than the recoverable amount of assets of that class.

(d) Disclosure

The following information should be disclosed in the financial statements:

(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 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.

10.4 Accounting for Government Grants (AS-12)

(a) Scope

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

This Standard does not deal with

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

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

(iii) Government participation in the ownership of the enterprise.

(b) Definitions

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

1. Government refers to government, government agencies and similar bodies whether local, national or international.

2. Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

(c) Main Principles

1. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

2. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a particular fixed asset equals the whole, or almost the

whole, of the expenditure of the asset, the asset should be given in the balance sheet at a nominal value. On the other hand, grants from government related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be owed to income over the periods and in the proportions in which depreciation on those assets is charged. Grants connected to non-depreciable possessions should be credited to capital reserve as per this method. Although, if a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred earnings balance should be separately disclosed in the financial statements.

2. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

3. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

4. Government grants in the form of non-monetary assets, agreed at a concessional price, should be accounted for on the basis of their purchase cost. In case a non-monetary possessions is given free of cost, it should be recorded at a nominal value.

5. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be documented and disclosed in the profit and loss statement of the period in which they are due, as an extraordinary item if appropriate (see

Accounting Standard (AS) 5, Net Profit or Loss for the time, Prior Period Items and Changes in Accounting Policies).

6. A contingency related to a government grant, come to pass after the grant has been documented, should be considered in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring after the Balance Sheet Date.

7. Government grants that become refundable should be accounted for as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the time, Prior Period Items and Changes in Accounting Policies).

8. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the point that the sum refundable exceeds any such deferred credit, or where non deferred credit exists, the sum should be charged to profit and loss account. The sum refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred revenue balance, as suitable, by the amount refundable. In the first option, i.e., if the book value of the asset is increased, depreciation on the new book value should be provided prospectively over the residual useful life of the asset.

9. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Accounting Treatment of Government Grants

1. **Capital Approach versus Income Approach**

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

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

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

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

b. Arguments in support of the 'income approach' are as follows

(i) Government grants are rarely gratuitous. The enterprise earns them through compliance with their conditions and meeting the envisaged 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.

It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standard (AS) 1, Disclosure of Accounting Policies).

In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

Recognition of Government Grants

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

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

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

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

2. A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.

3. In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which

the enterprise qualifies to receive it, as an extraordinary item if appropriate, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

4. Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

Non-monetary Government Grants

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

Presentation of Grants Related to Specific Fixed Assets

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

2. Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

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

4. Under the other method, grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable

5. The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

Presentation of Grants Related to Revenue

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

2. Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation.

Presentation of Grants of the nature of Promoters' contribution

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

Refund of Government Grants

1. Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

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

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

4. 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.

(d) Disclosure

The following should be disclosed:

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

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

10.6 Summary

As time progressed, a natural evolution in accounting became evident. Industrial revolution and voluminous transactions in a complex financial and business environment led to need-based accounting, specific to the nature of transactions involved. The Central Board Of Direct Tax (CBDT) has notified two accounting standards vide notification dated 25.1.1996 in terms of the provisions under section 145(2) of the Income Tax Act - Accounting standard I relating to Disclosure of Accounting Policies and Accounting Standard II relating to Disclosure of Prior Period and Extraordinary Items and Changes in Accounting Policies. These Accounting Standards are to be followed by all assesses following the mercantile/accrual system of accounting. In general, the mandatory Accounting Standards(as issued by ICAI) are applicable to financial statements and other financial reporting which are statutorily required to be audited under any law (including audit covered under Sec 44AB of Income Tax Act, 1961).

10.7 Keywords

Government: It refers to government, government agencies and similar bodies whether local, national or international.

Government grants: There are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Fair market value: It 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.

Gross book value: It 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.

10.7 Review Questions

1. Define the term 'accounting standard'. Explain accounting provisions related government grants as per Indian Accounting Standard.
2. Define the term 'Fixed assets'. Explain various accounting terminology related to fixed assets as Indian Accounting standard.
3. Define the term Revenue. Explain various accounting provisions in relation to revenue recognition as per Indian Accounting Standards.

10.8 Further Readings

1. Ghosh T.P., Allied **Accounting Standards and Corporate accounting practices**, Taxmann.
2. Gupta R.L. and Radhaswamy M., **Advanced Accountancy**– Sultan Chand & sons, New Delhi
3. Shukla M.C. & Grewal S, **"Advanced Accounts"**S. Chand &Company Ltd, New Delhi.
4. Paul S.K.R., **Advanced Accountancy**, New Central Book Agency- Calcutta.
5. Arulanandam M.A. & Raman K.S., **Advanced Accountancy**, Himalaya Publishing House-Delhi.