

NETAJI SUBHAS OPEN UNIVERSITY

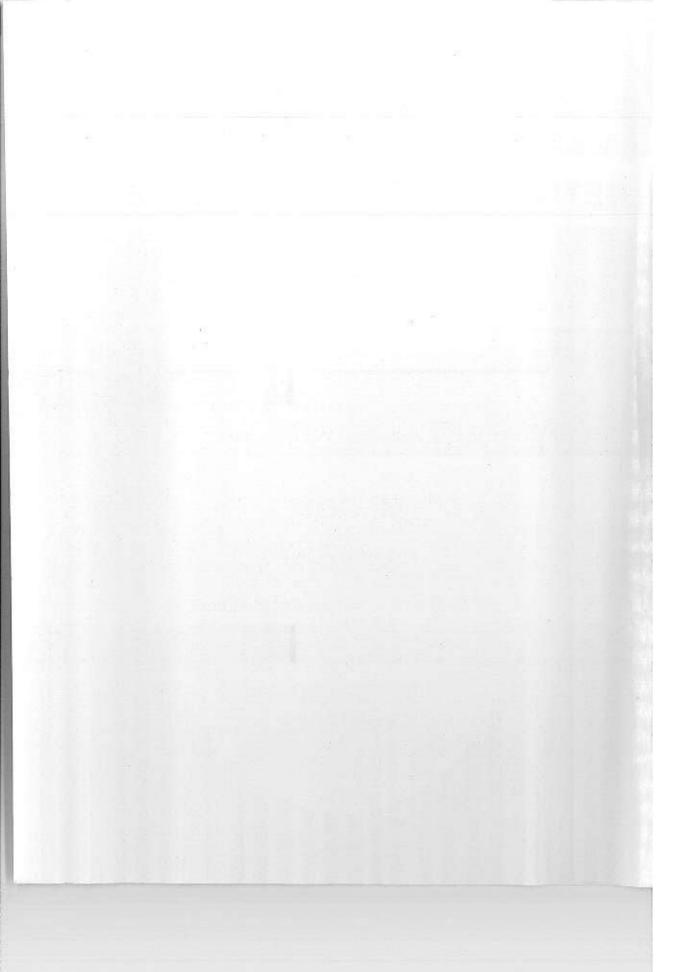
STUDY MATERIAL

M. COM.

PAPER-10

Advanced Financial Accounting

POST GRADUATE COMMERCE



PREFACE

In the curricular structure introduced by this University for students of Post-Graduate degree programme, the opportunity to pursue Post-Graduate course in Subject introduced by this University is equally available to all learners. Instead of being guided by any presumption about ability level, it would perhaps stand to reason if receptivity of a learner is judged in the course of the learning process. That would be entirely in keeping with the objectives of open education which does not believe in artificial differentiation.

Keeping this in view, study materials of the Post-Graduate level in different subjects are being prepared on the basis of a well laid-out syllabus. The course structure combines the best elements in the approved syllabi of Central and State Universities in respective subjects. It has been so designed as to be upgradable with the addition of new information as well as results of fresh thinking and analyses.

The accepted methodology of distance education has been followed in the preparation of these study materials. Co-operation in every form of experienced scholars is indispensable for a work of this kind. We, therefore, owe an enormous debt of gratitude to everyone whose tircless efforts went into the writing, editing and devising of proper lay-out of the meterials. Practically speaking, their role amounts to an involvement in invisible teaching. For, whoever makes use of these study materials would virtually derive the benefit of learning under their collective care without each being seen by the other.

The more a learner would scriously pursue these study materials the easier it will be for him or her to reach out to larger horizons of a subject. Care has also been taken to make the language lucid and presentation attractive so that they may be rated as quality self-learning materials. If anything remains still obscure or difficult to follow, arrangements are there to come to terms with them through the counselling sessions regularly available at the network of study centres set up by the University.

Needless to add, a great part of these efforts is still experimental—in fact, pioneering in certain areas. Naturally, there is every possibility of some lapse or deficiency here and there. However, these to admit of rectification and further improvement in due course. On the whole, therefore, these study materials are expected to evoke wider appreciation the more they receive serious attention of all concerned.

Professor (Dr.) Subha Sankar Sarkar Vice-Chancellor Eighth Reprint — December, 2018

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POST GRADUATE: COMMERCE

[M. Com.]

Paper—10 Modules-1 & 2 Advanced Financial Accounting

: Course Writing :

Prof. Subhas Chandra Sarkar

: Editing :

Prof. Swagata Sen

Notification

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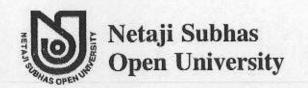
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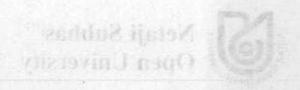
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Structure

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1.0 Objective

By the time you have gone through this chapter you should be able to:

- understand the disclosure requirements of the Companies Act, 1956;
- know the disclosure requirements as per the Accounting Standards prescribed by the Institute of Chartered Accountants of India (ICAI) up to June, 2002; and
- know the disclosure requirements as per the Securities and Exchange Board of India (SEBI) guidelines.

1.1 Introduction

Financial statements are usually prepared to provide useful financial information to the users. One may argue that only financial information is to be disclosed through preparation and presentation of company accounts. Only financial information is not sufficient to satisfy the need of the large number of users. Considering the need of different interested parties—investors in particular and others in general—information must mean both financial information and non-financial information, which are very much useful to the users in taking potential economic decisions. In the context of globalisation, corporate reporting should be need based of the investors and other interested parties. In India, many companies do not provide information according to the need of the users. In order to ensure adequate and effective corporate reporting in the interests of the investors and others, disclosure requirements of the Companies Act 1956, the Accounting Standards (AS) as prescribed by the ICAI and the SEBI guidelines are required to be followed strictly.

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1.2 Objectives of Disclosure

Now-a-days accounting is recognised as a prestigious profession. In order to discharge the responsibilities of any profession properly, one has to perform different functions. Accounting is not an exception to this rule. So accounting has to perform multifarious functions. The functions of accounting rightly starts from recording, classifying, summarising, and measuring business transactions and ends at communicating the results to the interested parties. Communication of information is made through reporting. One may raise question as to the need for disclosure of information. Thus the relevant issues in corporate accounting disclosure are:

- 1. Are the companies violating disclosure requirements?
- 2. Are the companies lagging far behind in disclosing information as per need of the users?
- 3. Are the companies voluntarily disclosing potentially useful information to the users for taking economic decisions?

Many more similar questions may be raised. All such questions attempt to evaluate the present state of practices of disclosure of information by Indian corporate houses so that users' needs are adequately fulfilled or partially fulfilled. In this context, it is highly

relevant to mention that prior to the 1980s, most of the Indian companies published the legally required minimum financial information while reporting. They kept many facts and figures hidden from the users. Some of the companies also violated the provisions of law. At present some Indian companies disclose information voluntarily. But the types and nature of such information are not conducive for taking useful economic decisions. However, some Indian companies are much ahead of the requirements in disclosing potentially useful economic information in the form of annual accounts including schedules, charts and other supplementary statements.

The corporate reporting practices in India are different among the corporate houses. As a result users are not getting uniform nature of information. Delivering information of diverse nature by different companies is not considered a healthy practice and this undoubtedly disseminates confusing and wrong signals to the users. Thus, keeping in view the bringing of uniformity in corporate reporting practices in general and the necessity of providing potentially useful information to the users for taking economic decisions in particular, supplying better and qualitative information is the need of the hour.

The business circuit of corporate houses is not confined to any particular country's national territory; it is spread all over the world after the emergence of free market economy in most of the countries. Also the free market economy wave throughout the world has brought many changes and will bring about more changes in all fields of economic activity including the accounting. So, corporate reporting practices should be improved over the existing ones as to make them capable of satisfying the need of the world-wide-scattered users. The uniformity in qualitative corporate reporting practices helps not only the corporate houses in fulfilling their desired objects but also the national economy in its smooth sailing towards goal.

From the above discussion it is apparent that corporate reporting practices are yielding divergent outcomes not only for the users but also for the companies themselves in the matter of attracting prospective investors. Some companies are violating the law of the land in fulfilling the disclosure requirements, some are lagging far behind of it and only a few are providing voluntarily the qualitative information more than what is expected. Thus, for providing qualitative information to fulfill the need of the users, corporate reporting practices should be governed by the law of the land in the light of changing economic scenario of the globe.

1.3 Need for Regulation of Corporate Account and Reporting

We usually go to physicians, nursing homes or hospitals for getting us cured of disease or diseases. Occasionally, we may go to the residence of our physician-friend solely with an intention of showing social gesture. But, when we suffer from diseases, we perforce become patients of a physician who prescribes medicines for us in order to cure diseases. Thus, disease forces us to go to physicians. Had there been no disease, we would not have felt the need of doctors.

Similarly, had the Indian corporate reporting practices been of proper quality and capable of satisfying the need of users of information, the question of regulation of corporate accounting and reporting would not arise at all. But the past and present state of corporate reporting practices are not free from shortcomings, i.e. diseases. For complete curing or at least partial curing of diseases of corporate reporting practices, we must have to search for appropriate physician. Companies Act 1956, the ICAI and the SEBI are the prominent physicians in India in detecting the diseases of corporate reporting and as such, they prescribed accordingly.

With a view to bringing uniformity in accounting policies and reporting practices and for providing potentially useful information, both financial and non-financial, by the corporate business houses to the users for taking economic decisions, the need for corporate legislation and regulating of accounting was felt during British India regime. As a result, in the year 1956, the first corporate legislation of independent India, the Companies Act, 1956 was passed by the Parliament. Companies Act, 1956 was amended several times according to the need of the social, economic, political and corporate environment of the country. The main objective of corporate legislation and regulation of accounting is to govern the corporate business houses within the framework of law in the matter of preparation and presentation of annual accounts so that comparability and uniformity in respect of both financial and non-financial information can be delivered to the worldwide scattered users.

In the present world, accounting is considered as one of the most important functions of business. Naturally, the degree of regulation is ever increasing to cope with the changes that are taking place throughout the globe. The developed countries in particular are much ahead in the matter of legislation and regulation of corporate accounting and developing countries in general too have already taken necessary steps in this direction. India is trying hard to cope with all these changes.

The study of corporate accounting regulation has gained importance over the last few years as it involves some vital issues like governance, administration, surveillance, supervision, legislation, etc. in the domain of accounting. Since accounting is a multi-disciplinary study, a variety of theories are moving around the concept of accounting regulation. Accounting regulation refers to the act of making accounting process regular, and/or the act of controlling, governing, correcting and adjusting it by rule or provision of law.

Till the first quarter of the 20th century, when the objectives of the preparation of financial statements were primarily to reveal the wealth generated and income carned by the proprietor, self-regulation was considered sufficient. But now, when accounting provides more than one interested parties with quantitative financial information that helps them to make decisions about the employment and use of resources in business and non-business entities and the reports are consulted by a large section of the people (including government) who have a wide range of interest in them (though in varying degrees), self-regulation has been justifiably replaced by some outside agencies. Thus, in modern times, accounting regulation means regulation by other outside agencies like government, regulatory agencies established by government, etc.

Corporate form of businesses having separation between ownership and management came into existence during mid-eighteenth century, and it required quantities of capital greater than what could be provided by an individual or a family. These were soon proved to be the most satisfactory form of business organisation and gradually were considered a cornerstone in the trading structure of the world. The separation between ownership and management has created another separation between 'financing function' and 'managerial function', as a result of which there has cropped up a number of accounting challenges and financial accounting and reporting has got an important social status. Since managers of corporate business houses manage other people's money rather than their own, it cannot be expected that they should look over it with the same anxious vigilance as the real owners do with respect to the management of the affairs of the business including financial function. In this situation, fraud and misappropriation of fund are also very likely to occur. During 1960s, financial reporting system was made the subject of much criticism on some strong and reasonable grounds, like (i) lack of uniformity in accounting practice that made difficult the comparison of different companies; (ii) the multiplicity of accounting practices that made it possible for the management to select alternative presentations of financial results which allowed earning to be manipulated and made it possible to conceal economic realities; etc.

A government cannot allow this situation and act as a passive observer. It felt, therefore, the necessity of regulating the corporate accounting and management, and started promulgating the Companies Act, keeping in view the objective of protecting the interests of investors and other interested parties. Again, every democratic government with an aim of maximising the social welfare has the capacity of being an independent and impartial regulator. Moreover, accounting profession of almost all countries is in favour of imposing regulation on corporate accounting and reporting. Thus, regulation of accounting is not only desirable, but also essential in the interests of all concerned. But there remain differences as to the approach of regulation among countries.

It is therefore imperative to have regulation in accounting. Accounting has also accepted its importance for its healthy improvement and progress. Several provisions of the Companies Act, case laws and other regulatory requirements now guide both maintenance of books of account and financial reporting. It is to be remembered that accounting regulation should be consistent with some pre-determined objectives. These objectives cannot, again, be static and uniform in all countries and throughout all times. Rather they will be dependent on the changing socio-economic need of the country concerned.

In India, the present framework of corporate accounting has a legal backbone. The corporate legislation in the form of the Companies Act, 1956 provides the basic rules and guidelines for presenting final accounts. The accounts are kept and presented according to the Indian Accounting Standards (AS) issued by the Institute of Chartered Accountants of India (ICAI) which derives its authority and power from another legislation known as the Chartered Accountants Act, 1949. The Securities and Exchange Board of India (SEBI), a regulatory body, has been working and making rules for governing stock markets in India over the last few years.

What the regulating agencies already did in respect of bringing uniformity in corporate accounting and reporting practices, and in providing large number of users with potentially useful information for taking economic decisions, are to be examined one by one in the paragraphs that follow.

1.4 Disclosure in Company Accounts as per Companies Act, 1956

Every limited company must prepare at the end of each financial year the Profit and Loss Account and the Balance Sheet. Section 209 makes it compulsory to keep certain

books of account along with their legal provisions and Section 210 governs the preparation of the final accounts.

1.4.1 Maintenance of books of account and their related provisions:

According to Section 209, companies must maintain proper books of account for proper recording along with their disclosure requirements for the following:

- All moneys received and paid by the company and the matters in respect of which the receipt and expenditure take place.
 - 2. All purchases and sales made by the company.
 - 3. All assets and liabilities of the company.
- Companies engaged in production, processing, manufacturing or mining activities, must maintain proper books of account relating to utilisation of raw materials, labour, etc. [Section 209(1)(d)].
- 5. Books of account and other books and papers must be open to inspection by directors [Section 209(4)].
- Books of account shall not deemed to be kept properly, if the books do not give true and fair view of the state of affairs, and if those are not kept on accrual basis and according to double entry system of accounting.
- 7. Defaulters will be punishable with imprisonment for 6 months and with fine of Rs.1,000.
- 8. Books of account of every company shall be open to inspection by the Registrar or by such officers of the government as may be authorised by Central Government in this behalf. Such inspection may be made without giving any prior notice to the company or any officer thereof [Section 209A].

1.4.2 Preparation and Submission of Annual Accounts:

Section 210 of the Companies Act, 1956 governs the preparation and submission of annual accounts of a company. Main provisions are given below:

- 1. At every annual general meeting of the company, the Board of Directors of the company shall lay before the company:
 - (a) a balance sheet as at the end of the accounting period; and
 - (b) a profit and loss account for that period.
- In case of a company not carrying on business for profit, an income and expenditure account shall be laid before the company at its first annual general meeting instead of profit and loss account.

- 3. The profit and loss account (or the income and expenditure account) shall relate to the period:
- (a) in case of first annual general meeting of the company from the date of incorporation of the company to a date not more than 9 months before the meeting; and
- (b) in case of any subsequent annual general meeting from the date immediately after the period for which the account was last submitted to not more than 6 months before the meeting.
- 4. The period for which the account has been prepared is referred to in this Act as a "financial year". It may be less than or more than a calendar year, but it shall not exceed 15 months. However, with the permission of the Registrar, it may extend to 18 months.

In view of the amendment in the Income Tax Act, 1961, the financial year must begin on 1st April and end on 31st March of the subsequent calendar year, w. e. f. financial year ending 31st March 1989.

- Every profit and loss Account shall give a true and fair view of the profit and loss
 of the company for the financial year and subject to as aforesaid, comply with the
 requirements of Part II of Schedule VI, so far as they are applicable thereto [Section
 211(2)].
- 6. Every balance sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of financial year and shall, subject to the provision of this section, be in the form set out in Part I of Schedule VI, or as near thereto as circumstances admit or in such other form as may be approved by the Central Government; and in preparing the balance sheet due regard shall be had, as far as may be, to the general instructions for preparation of balance sheet under the heading "Notes" at the end of the part [Section 211(1)].
- 7. The Companies (Amendment) Act, 1999 requires to prepare profit and loss account and balance sheet in accordance with the accounting standards. Sub-sections (3A), (3B) and (3C) inserted by the Act in section 211 of the Companies Act, 1956, which contain these provisions, read as below:
- (3A): Every profit and loss account and balance sheet of the company shall comply with the accounting standards.
- (3B): Where the profit and loss account and the balance sheet of the company do not comply with the accounting standards, such companies shall disclose in its profit and loss and balance sheet (a) deviation form the accounting standards, (b) the reasons for such deviation; and financial effect arising due to such deviation.

(3C): For the purposes of this section, the terms 'accounting standards' means the standards of accounting recommended by the ICAI constituted under the Chartered Accountants Act, 1949.

1.4.3 Audit of Accounts:

The important provisions relating to audit of accounts of a company are as follows:

- 1. The auditor shall make a report on the accounts examined by him and on balance sheet and profit & loss account and other documents. The report shall state whether in his opinion and to the best of information given to him, the said accounts give a true and fair view, in case of balance sheet, of the state of affairs, and in case of profit and loss account, of the profit or loss. It also states:
- (a) whether he has obtained all information and explanations necessary for his audit;
- (b) whether proper books of account have been kept by the company and proper returns have been received from branches, and whether the report on the accounts of any branch office audited under Section 228 by a person other than the company's auditor has been forwarded to him; and
- (c) whether the company's balance sheet and profit and loss account are in agreement with the books and returns [Section227(2) and (3)].
- Every auditor shall state whether, in his opinion, the profit and loss account and balance sheet complied with the accounting standards referred to in sub-section (3C) of section 211 and 227(3)(1)(d).
- 3. Every auditor shall have the right of access at all times to the books of account and vouchers of the company whether kept at head office or elsewhere, and shall be entitled to require from the officers, such information and explanations as the auditor think necessary. He shall also inquire:
 - (a) whether loans and advances made by the company have been properly secured;
- (b) whether transactions of the company are not detrimental to the interest of the company;
- (c) where the company is not an investment company; whether the securities are sold at a price less then the purchased price;
 - (d) whether loans and advances made have been shown as deposits;
 - (e) whether personal expenses have been charged to revenue accounts;
- (f) where it is stated in the books and papers that any shares have been allotted for cash, whether cash has actually received, and if not, whether the position as stated in the books of account is correct, regular and not misleading [Section 227(1) and (1A)].

1.4.4 Directors' Report:

The Directors' Report of a company must contain the following:

- 1. There shall be attached to every balance sheet, a report by its Board of Directors, with respect to:
 - (a) the state of company's affairs;
 - (b) the amount which it proposes to carry to any reserve;
 - (c) the amount which it recommends should be paid by way of dividend;
- (d) material change and commitments, if any, affecting the financial position of the company;
- (e) changes which have occurred in the nature of company's business in which the company has an interest;
- (f) name of each employee whose remuneration is at least Rs.72,000 per year or Rs.6,000 per month;
- (g) the conservation of energy, technology absorption, foreign exchange carnings, and outgo;
 - (h) mames of the employees who are the relatives of directors and managers; and
- (i) every reservation, qualification or adverse remark contained in the auditor's report [Section 217].
 - 2. The report must state that the directors have :
- (a) followed, in the preparation of annual accounts, the applicable accounting standards with proper explanation with respect to material departures;
- (b) selected such accounting policies and applied them consistently and made judgments and estimates that are reasonable and prudent so as to give a true and fair view of the state of affairs of the company at the end of the financial year and of the profit and loss of the company for that period;
- (c) taken proper and sufficient care for the maintenance of adequate accounting records in accordance with the provisions of the Companies Act, 1956, for safeguarding the assets of the company and for preventing and detecting fraud and other irregularities; and
- (d) prepared the annual accounts on a going concern basis under Section 217(2AA) of the Companies (Amendment) Λct, 2000.

1.5 Disclosure in Company Accounts as per Accounting Standards of ICAI

The main objective of accounting standard setting is to maintain uniformity in the presentation of economic data contained in the annual accounts of corporate enterprises. In other words, it aims at harmonising the diverse accounting policies and practices adopted by different enterprises and ensuring consistency in the reported information of an enterprise from year to year so that users of financial statements are in a position to understand and make proper use of the statements for decision purposes. The ICAI has prescribed 28 standards so far. The most important Accounting Standards (AS) along with disclosure requirements are explained as follows:

AS-1: Disclosure of Accounting Policies

AS-1 deals with the disclosure of significant accounting policies followed in the preparation and presentation of financial statements. Also it states that going concern, consistency and accrual are fundamental accounting assumptions that underlie the preparation and presentation of financial statements.

Regarding disclosure requirements, it stipulates that :

- (a) the significant accounting policies should normally be disclosed in one place;
- (b) any change in the accounting policies which has a material effect in the current period or which is reasonably expected to have a material effect in later period should be disclosed; and
- (c) the non-compliance of fundamental accounting assumption in the preparation financial statements should be disclosed.

With effect from the accounting year commencing on or after 1:4.1993, it was made mandatory for all enterprises.

AS-2: Valuation of Inventories

This standard deals with the principles of valuation of inventories for the purpose of financial statements. It defines inventory as a tangible property held (i) for sale in the ordinary course of business (finished goods), (ii) in the process of production for such sale (work-in-progress), or (iii) for consumption in the production of goods or services for sale including maintenance supplies and consumables other than machinery spares (raw materials, stores and spares). Valuation of inventories should be at cost, or net realisable value, which ever is less. The cost of inventory should comprise (a) all cost of purchase (purchase price, duties and taxes, freight inward and other directly attributable expenses less discounts, rebates, etc.), (b) costs of conversion (direct labour and

overhead), and (c) other costs incurred in bringing the inventories to their present location and condition (excluding interest and borrowing costs).

As regards disclosure requirements, AS-2 states that the financial statements should disclose the following:

- (i) the accounting policies followed in measuring inventory values including the cost formula used, and
- (ii) total carrying amount of inventories and its classification appropriate to the enterprise.

With effect from the accounting year commencing on or after 1.4.1999, it was made mandatory for all enterprises.

AS-3: Cash Flow Statements

The main objective of AS-3 is to disclose cash flows arising out of three broad classifications so that users of cash flow information can evaluate solvency position and project future cash flows of companies for taking economic decisions.

Regarding disclosure requirements, AS-3 states that a cash flow statement should be divided into three heads, viz., (a) cash flows from operating activities, (b) cash flows from investing activities, and (c) cash flows from financing activities.

In India, preparation of cash flow statement is not mandatory for all companies. But, with effect from the accounting year starting on or after 1.4.2001, it was made mandatory in respect of:

- (a) listed companies or companies whose shares and debentures are in the process of enlisting on a recognised stock exchange in India;
- (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

AS-4: Contingencies and Events Occurring after the Balance Sheet Date

It deals with the treatment in the financial statements of contingencies and events occurring after balance sheet date.

AS-4 requires disclosure only in respect of those contingencies and events, which affect the financial position to a material extent. It also requires that if a contingent loss is not provided for, its nature and an estimate of its financial effect, or a statement that such an estimate cannot be made, should be disclosed.

It was made mandatory with effect from the accounting year starting on or after 1.4.1995 for all companies.

AS-5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies

This standard deals with the treatment in the financial statements of prior period and extraordinary items and changes in accounting estimates and accounting policies. Also, it defines ordinary activities, extraordinary items, prior period items, accounting estimates and accounting policies.

AS-5 requires disclosure in respect of:

- any change in an accounting policy which has a material effect should be disclosed in the period in which such change is made. But, where the effect of such change cannot be ascertained, wholly or partly, the fact should be disclosed.
- any change in an accounting policy has no material effect in the current period but is expected to have a material effect in the later period, the fact of such change should be appropriately disclosed in the period in which such change is made.
- the nature and amount of each extraordinary item should be disclosed in the profit and loss account.

With effect from 1.1.1987, it was made mandatory for all enterprises.

AS-6: Depreciation Accounting

It deals with the accounting for depreciation and disclosure requirements in connection therewith. Depreciation has a significant effect in ascertaining the results of operation of an enterprise and in presenting its financial position.

AS-6 contains following important disclosure requirements in the financial statements:

- The historical cost or other amount substituted for historical cost of each class of depreciable assets;
 - 2. Total depreciation for the period for each class of assets;
 - 3. The related accumulated depreciation;
 - 4. Method of depreciation used;
- 5. Depreciation rates or the useful lives of assets, if they are different from the principal rates specified in the statute governing the enterprise; and
- Net surplus or deficiency (if material) of an asset disposed of, discarded, demolished or destroyed.

With effect from the accounting year starting on or after 1.4.1995, it was made mandatory for all enterprises.

AS-7: Accounting for Construction Contracts

This standard deals with the accounting for construction contracts and disclosure requirements therewith. The period covered by construction contracts is usually spread over more than one accounting year and this poses many accounting problems relating to revenue recognition and presentation of figures of advances received, work-in-progress, etc. in the financial statements. The standard recognises two methods of accounting for construction contracts, viz., the percentage of completion method and the completed contract method. When a contractor uses a particular method, then the same should be applied for all other contracts.

AS-7 requires a number of disclosure requirements in the financial statements, viz. :

- 1. The amount of construction work-in-progress;
- Progress payments received and advances and retentions on account of contracts included in construction work-in-progress; and
- Changes in an accounting policy used for construction contracts giving the effect of the change and its amount.

With effect from the accounting year commencing on or after 1.4.1991, it was made mandatory for construction companies.

AS-8: Accounting for Research and Development

The standard deals with the treatment of costs of research and development in the financial statements and their disclosure. AS-8 also identifies items of costs, which comprise research and development and suggests that (a) the research and development costs are to be charged to expenses in the period in which they are incurred; and (b) the deferred research and development costs are to be amortised on a systematic basis.

AS-8 requires the disclosure of the following in the financial statements:

- Research and development costs, including the amortisation of deferred costs, charged as an expense of each period;
- The unamortised balance, if any, of deferred research and development costs;
- The accounting policy adopted for research and development costs.
 With effect from the accounting year starting on or after 1.4.1991, it was made mandatory for all companies.

AS-9: Revenue Recognition

This standard deals with the timing of recognition of revenue in the profit and loss account of an enterprise. It defines revenues as the gross cash inflow, receivables or other consideration in the course of ordinary business activities of an enterprise from the (a) sale of goods, (b) rendering services, and (c) use of enterprise's resources by others yielding interest, royalties and dividends.

As regards disclosure in the financial statements, AS-9 stipulates that, in addition to the disclosures required as per AS-1, an enterprise is required to disclose the circumstances in which revenue recognition has been postponed pending the resolution of significant uncertainties.

With effect from the accounting year commencing on or after 1.4.1991, it was made mandatory for all companies.

AS-10: Accounting for Fixed Assets

This standard deals with the identification of fixed assets, costs of fixed assets, their accounting and disclosures. As per the standard, a 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. The gross book value of a fixed asset should be either historical cost or revalued amount computed as per the standard. Cost comprises its purchase price, including import duties and other non-refundable taxes or levies and any directly attributable cost of bringing the assets to its working condition or its intended use. The standard once again states that only purchased goodwill should be recorded as an item of fixed assets.

Regarding disclosure requirements, the following should be disclosed in the financial statements:

- Gross and net book values of fixed assets at the beginning and end of the accounting period showing additions, disposals, acquisitions and other movements;
- Expenditure incurred on fixed assets in the course of construction or acquisition;
- 3. Revalued amount substituted for historical costs of fixed assets, the method applied 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.

AS-10 was made mandatory w. e. f. the accounting year starting on or after 1.4.1991 for all enterprises.

AS-11 : Accounting for Effects of Changes in Foreign Exchange Rates

The standard deals with the issues in accounting for foreign currency transactions and foreign branches. Also it decides exchange rate to use and how to recognise the effect of changes in exchange rates in the financial statements.

Regarding disclosure requirements, an enterprise should disclose the following:

- 1. The amount of exchange differences included in the net profit or loss for the period;
- The amount of exchange differences adjusted in the carrying amount of fixed assets during the accounting period; and
- The amount of exchange differences in respect of forward exchange contracts to be recognised in the profit or loss account for one or more subsequent accounting periods.

AS-11 was made mandatory, w. e. f. the accounting year starting on or after 1.4.1995 for all enterprises.

AS-12: Accounting for Government Grants

AS-12 deals with the accounting for receipt of government grants by an enterprise and its disclosures in the preparation of financial statements. It is desirable to give an indication of the extent to which the enterprise has benefited from such grant during the accounting period with a view to facilitating both inter-period and inter-firm comparison.

An enterprise should disclose the following in the financial statements:

- Accounting policy for government grants, including methods of presentation;
- The nature and extent of government grants recognised, including grants for non-operating assets given at a concessional rate or free of cost.

This standard was made compulsory w. c. f. the accounting year commencing on or after 1.4.1994 for all enterprises.

AS-13: Accounting for Investments

AS-13 requires classification of investments into long term and current (short term) investments on the basis of intention to hold such investments. Cost of an investment comprises purchase price and acquisition charges such as brokerage, fees and stamp duties. Long term investments are valued at cost and permanent decline in market value is recognised while current investments are valued at cost or market price, whichever is lower and are treated in the line of current assets.

The following disclosures in the financial statements are required to be made:

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

With effect from the accounting year starting on or after1.4.1995, it was made mandatory for all enterprises.

AS-14 : Accounting for Amalgamations

This standard deals with the accounting for merger (where there is a genuine pooling not only of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies) and acquisition or purchase (one company acquiring another company and as consequence the shareholders of the acquired company normally do not continue to have a proportionate share in the equity of the combined company or the business of the acquired company is not intended to be continued) and disclosures in connection therewith. The standard recognises two accounting methods of accounting for amalgamations. They are (a) pooling of interests method, and (b) purchase method.

The pooling of interests method is adopted in case of an amalgamation in the nature of merger whereas purchase method is used in case of an amalgamation in the nature of purchase.

Under pooling of interests method, the assets, liabilities and reserves of the transferor company are recorded by the transferoe company at their existing carrying amounts with suitable adjustments. But, under the purchase method, the transferee

company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values at the date of amalgamation.

AS-14 requires both general and specific disclosures as below:

General disclosures:

- 1. Names and general nature of business of the amalgamating companies;
- 2. Effective date of amalgamation for accounting purposes;
- 3. The method of accounting used to reflect the amalgamation; and
- 4. Particulars of the scheme sanctioned under a statute.

Additional disclosures under the pooling of interests method:

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

Additional disclosures under the purchase method:

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

With effect from the accounting year commencing on or after 1.4.1995, it was made mandatory for all companies.

AS-15: Accounting for Retirement Benefits in the Financial Statements of Employers

The standard deals with the ascertainment, accounting and disclosures of retirement benefits in the financial statements of employers. Retirement benefit of employees usually consists of provident fund, superannuation/pension, gratuity, leave encashment benefit on retirement, post-retirement health and welfare schemes and other retirement benefits.

AS-15 contains the following provisions for disclosures:

- In view of the diversity in practices used for accounting of retirement benefits costs, adequate disclosure of method followed in determination of such costs is essential for an of the significance of such costs to an employer.
- Retirement benefits costs are sometimes disclosed separately for statutory compliance. In other cases, they are considered to be an element of employee remuneration and their separate disclosure is not usually made.
- 3. When retirement benefit costs are measured on the basis actuarial valuation, the date of such valuation and method of determination of periodical charges should briefly be described where such charges are not based on actuarial valuation.

With effect from the accounting year starting on or after 1.4.1995, it was made mandatory for all companies.

AS-16: Borrowing Costs

This deals with the accounting for borrowing costs and disclosures thereof. Borrowing costs are interest and other costs incurred by an enterprise with respect to the borrowing of funds. Borrowing costs that are directly attributable in the acquisition, construction or production of qualifying assets should be capitalised. A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for the intended use or sale. Other borrowing costs (which are not directly attributable to) are recognised as an expense in the period in which they are incurred.

Financial statement of an enterprise must disclose the following:

- 1. Accounting policy adopted for borrowing costs; and
- 2. Amount of borrowing costs capitalised during the period.

With effect from the accounting year commencing on or after 1.4.2000, it was made mandatory for all companies.

AS-17: Segment Reporting

It deals with the disclosure of information on the basis of segment of an enterprise in the financial statements. The objective of segment reporting is to establish principles for reporting financial information in annual financial statements by segment i. e. information about the different types of product and services an enterprise produces and the different geographical areas in which it operates.

It distinguishes between business (or industrial) segment and geographical segment and identifies the factors that are to be taken into consideration in their determination.

A business segment is a distinguishable component of an enterprise that is engaged in providing an individual product or service or group of related products or services and that is subject to risks and returns that are different from those of other business segments. On the contrary, a geographical segment is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments.

After completion of identification of business and geographical segments, management has to ascertain whether these segments are 'reportable segments' for which segment information is required to be disclosed. As per the standard, a segment with 10% or more of total revenues, profit (or loss) or identifiable assets becomes a reportable segment. The standard also stipulates that if total external revenue attributable to reportable segments constitutes less than 75% of the total revenue of the enterprise, additional segments should be identified as reportable segments, even if they do not meet the 10% thresholds, to make the revenue of the reportable segments at least equivalent to 75% of total revenue of the enterprise.

For the purpose of disclosure of segmental information, the standard also distinguishes between primary segment and secondary segment and suggests primary and secondary reporting formats respectively for them. The dominant source and nature of risks and returns of an enterprise determine the primary segment. For example, if risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if risks and returns of an enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas, its primary format for reporting segmental information should be geographical segments, with secondary information reported for groups of related products and services.

According to AS-17, disclosure requirements in the financial statements are as follows:

- A reportable segment must disclose its revenue, expenses, profit or loss, assets, liabilities and accounting policies.
- 2. Once a segment disclosure is made in the previous accounting year based on 10% thresholds, disclosure of information for the same segment must be made in the current year also in spite of failure to meet 10% thresholds along with previous year's figures, unless it is impracticable to do so.

AS-17 was mandatory with effect from the accounting year 1.4.2001 for (a) listed companies or companies whose shares and debentures are in the process of enlisting on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard; and (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

AS-18: Related Party Disclosure

This standard deals with the reporting of related party relationships and transactions between a reporting enterprise and related parties. The requirements of the standard are not only applicable to the financial statement of each reporting enterprise but also to the consolidated financial statements presented by a holding company. It requires disclosure of name of the related party and nature of related party relationships where control exists in such relationship irrespective of whether not there have been transactions between related parties.

AS-18 requires disclosure as noted below in the financial statement of reporting enterprise for transactions between related parties, during the existence of related party relationship:

- 1. The name of the transacting related party;
- 2. A description of the relationship between the parties;
- 3. Volume of the transactions either in terms of amount or in terms of proportion;
- Any other elements of the related party transactions necessary for an understanding of the financial statements;
- The amount or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and
- Amounts written off or written back in the period in respect of debts due from related parties.

It is to be remembered that no disclosure is required for state-controlled enterprises in the matter of related party relationships with other state-controlled enterprises. Again, no disclosure is required in consolidated financial statements in respect of intra-group transactions.

With effect from the accounting year starting on or after 1.4.2001, it was made mandatory for all enterprises.

AS-19 : Leases

It deals with the accounting of transactions relating to leases other than (a) lease agreement to explore for, or use of, natural resources; (b) licensing agreements for items such as motion picture films, video recordings, plays manuscripts, patents and copyrights; and (c) lease agreements to use lands. The standard classifies leases into 'finance lease' and 'operating lease' on the basis of the extent to which risks and rewards incidental to the ownership of a leased assets lie with lessor or lessee. A lease is considered as finance lease if it transfers substantially all the risks and rewards incidental to ownership. Title may or may not eventually be transferred. On the contrary, a lease that does not transfer substantially all risks and rewards incidental to ownership is termed as operating lease.

As regards finance lease, it provides for recognition of such a lease as asset as well as liability in the books of lessee at an amount equal to the fair value of the leased assets at the start of the lease. A lease payment by the lessee is required to be apportioned between the finance charge and the outstanding liability. Moreover, the lessee is entitled to provide depreciation for a leased asset in accordance with AS-6.

The standard demands *disclosure* in detail in respect of a *finance lease* in the books of the lessor and lessee. The most important disclosure requirements are as follows:

The lessee must, in addition to requirements of AS-10, AS-6 and the governing statute, make the following disclosures in the financial statements:

- 1. Assets acquired under finance lease as segregated from the assets owned;
- 2. For each class of assets, the net carrying amount at the balance sheet date;
- 3. A reconciliation between the total of minimum lease payments at the balance sheet date and their present value. Moreover, an enterprise must disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:
- (a) not later than one year; (b) later than one year but not later than 5 years; (c) later than 5 years;
- Contingent rents recognised as income in the statement of profit & loss for the period;
- The total of future minimum sub-lease payments expected to be received under non-cancellable sub-leases at the balance sheet date; and

- 6. A general description of the lessee's significant leasing arrangements including, but no limit to, the following:
- (a) the basis on which contingent rent payments are ascertained; (b) the existence and terms of renewal or purchase options and escalation clauses; and (c) restrictions imposed by lease arrangements, such as those concerning dividends, additional debts, and further leasing.

The lessor must make disclosures in the financial statements in respect of the following:

- 1. A reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise must disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the periods as below:
- (a) not later than one year; (b) later than one year but not later than 5 years; (c) later than 5 years;
 - 2. Unearned financial income;
 - 3. The unguaranteed residual values accruing to the benefit of the lessor;
- 4. The accumulated provision for uncollectible minimum lease payments receivable;
 - 5. Contingent rents recognised in the statement of profit & loss for the period;
 - 6. A general description of the significant leasing arrangements of the lessor; and
 - 7. Accounting policy adopted in respect of initial direct costs.

With effect from the accounting year commencing on or after 1.4.2001, it was made mandatory for all enterprises.

AS-20: Earnings Per Share (EPS)

The aim of this standard is to provide principles for the determination and presentation of EPS which will improve comparison of performance among various enterprise for the same period and among various accounting periods for the same enterprise. The standard also provides the principles and the manner in which both basic and diluted EPS are to be computed. The basic EPS is determined as below:

Basic EPS = (Profits attributable to equity shareholders)/(Weighted average number of equity shares outstanding during the period)

All items of income and expenses including tax expenses, extra-ordinary items that are recognised in a period should be adjusted to arrive at net profit or loss. Net profit after tax minus preference dividends gives the 'profit attributable to equity shareholders' for the period. The 'weighted average number of equity shares outstanding during the period' is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time weighting factor. The time weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period.

The basic EPS figure could be misleading to users if, in the future, number of shares in issue will increase without a commensurable increase in resources due to dilutive factors, which are (a) convertible bonds, (b) convertible preference shares and (c) options and warrants. In this case both numerator and denominator should be adjusted in order to calculate diluted EPS as below:

Diluted EPS=(Diluted earnings attributable to equity shareholders)/(Weighted average number of shares outstanding adjusted for potential dilutive securities)

With a view to getting diluted earnings attributable to equity shareholders, net profit or loss for the period attributable to equity shareholders, calculated for ascertaining basic EPS, should be adjusted by the following, taking into account any attributable change in tax expenses for the period:

- 1. Any dividends on dilutive potential equity shares, which have been deducted in arriving at the net profit as above;
 - 2. Interest recognised in the period for the dilutive potential equity shares; and
- Any other charges in expenses or income that would result from the conversion of the dilutive potential equity shares.

The 'weighted average number of shares outstanding adjusted for potential dilutive securities' should be the total of the weighted average number of equity shares calculated for basic EPS and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

According to AS-20, basic EPS and diluted EPS should be disclosed prominently on the face of profit and loss account for each accounting period. This disclosure is required to be made even when the amounts disclosed are negative.

With effect from the accounting year starting on or after 1.4.2001, it was made mandatory for all enterprises whose equity shares are listed on a recognised stock exchange in India or, any enterprise whose equity shares is not listed on a recognised stock exchange in India and discloses EPS voluntarily.

AS-21: Consolidated Financial Statement

In India, the preparation of Consolidated Financial Statement (CFS) is not compulsory under the Companies Act, 1956. But, AS-21 requires the preparation of CFS by a holding company for a group of companies under its control, in addition, to its separate financial statement. Such CFS must consolidate all subsidiaries, domestic and foreign other than a subsidiary when (a) control is intended to be temporary because the subsidiary is acquired and held solely with a view to its subsequent disposal in near future; or (b) it operates under severe long-term restrictions, which significantly impair its liability to transfer funds to the parent.

The standard also requires that the financial statement used in consolidation should be drawn up to the same reporting date. If it is not possible for one or more subsidiaries to draw up the financial statement to such date, adjustments should be made for the effect of significant transactions or other events that occur between the dates on which financial statement of one or more subsidiaries are drawn and the date of the parent company's financial statement. Under no case, the difference between reporting dates should be more than 6 months.

According to AS-21, disclosure requirements are the following:

- 1. The reasons for not consolidating a subsidiary.
- When uniform accounting policies are not adopted for similar transactions for practical difficulties, the fact of such departure and quantum of items to which the different accounting policies have been followed.
- List of all subsidiaries including the name, country of incorporation, or residence, proportion of ownership and, if different, proportion of voting power held.
- 4. The nature of relationship between the parent and subsidiary, if the parent does not own, directly or indirectly through subsidiaries, more than half of the voting power of the subsidiary.
- The effect of the acquisition and disposal of subsidiaries on the financial position on the reporting date, the results for the reporting period and on the corresponding amounts for the preceding period.

6. The names of the subsidiary(ies) of which reporting date(s) is/are different from that of the parent and difference in reporting dates.

It was made mandatory for all parent companies w. c. f. the accounting year commencing on or after 1.4.2001.

AS-22: Accounting for Taxes on Income

The objective of this standard is to remove the difference between the incomes reported by profit & loss account and the taxable income determined by tax laws. The standard requires recognition of deferred tax assets and liabilities for timing differences subject to consideration of prudence as regards deferred tax assets. However, the discounting of deferred tax assets in terms of present value is not allowed. It also contains transitional provisions to recognise accumulated deferred tax balances in the financial statement as deferred tax assets or liabilities with corresponding credit charge to revenue reserves.

The standard requires disclosure for the following:

- Deferred tax assets and liabilities should be disclosed under a separate heading in the balance sheet, separately from current assets and liabilities.
- The break up of deferred tax assets and deferred tax liabilities into major components of the respective balances is required to be disclosed in the notes to accounts.

It was made mandatory for all companies w. e. f. the accounting year commencing on or after 1.4.2001.

AS-23: Accounting for Investment in Associates in Consolidated Financial Statement

An associate is an enterprise in which the investor has significant influence and which is neither a subsidiary nor a joint venture of the investor. AS-23 requires that there should be a differentiation between accounting of investment in associates from that in any other entity. It advocates that equity method should be adopted for accounting of such investment in associates while preparing consolidated financial statement (CFS).

In equity method, the investment is initially recorded at cost, identifying any goodwill or capital reserve arising at the time of acquisition and the carrying amount is increased or decreased to recognise the share in the investor in the profits or losses of the investce after the date of acquisition. Dividends received from an investee reduce the carrying amount of investment. When the investor ceases to have significant influences in associates it should discontinue the use of equity method.

The deviation from accounting under equity method is CFS is permitted when (a) the investment is acquired and held solely with a view to its subsequent disposal in near future; or (b) the associate operates under severe long-term restrictions, which significantly impair its ability to transfer funds to the investor.

According to AS-23, major disclosure requirements are as under:

- Investment in associates accounted for using equity method should be mentioned as long term investment and disclosed separately in CFS.
- An appropriate listing and description of associates including the proportion of ownership interest.
 - 3. The share of investor in the profits or losses on investments in associates.
- 4. A brief description of differences between accounting policies of associates and the investor when such different policies are applied for practical difficulties.
- Amount of goodwill or capital reserve arising on the acquisition of an associate that has been included in investment.
- 6. The reason for non-application of equity method in accounting for investments in an associate under certain special circumstances as allowed by the standard.

With effect from the accounting year commencing on or after 1.4.2002, it was made mandatory for all enterprises having investment in associates.

AS-24: Discontinuing Operations

The objective of this standard is to establish principles for reporting information about discontinuing operations, thereby enhancing the ability of users of financial statements in order to make projections of cash flows, earnings-generation ability, and financial position by segregating information about discontinuing operations from information about discontinuing operations of an enterprise.

The disclosure requirement arises on occurrence of the initial disclosure event with respect to a discontinuing operation. The initial disclosure event, is the occurrence of any one of the following, whichever is earlier:

- 1. The enterprise has entered into a binding sale agreement for substantially all of the assets attributable to the discontinuing operation; or
- The board of directors of the enterprise or similar governing body has both (a) approved a detailed formal plan for discontinuance, and (b) made an announcement of the plan.

An enterprise should disclose the following information with respect to discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure occurs:

- 1. A description of discontinuing operation(s);
- The business or geographical segments(s) in which it is reported in accordance with AS-17;
 - 3. The date and nature of the initial disclosure event:
- The date and period in which the discontinuance is expected to be completed if known or determinable;
- The carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;
- The amounts of revenue and expenses in respect of ordinary activities attributable to the discontinuing operation during the current financial reporting period;
- The amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the incometax expenses related thereto; and
- 8. The amounts of net cash flows attributable to the operating, investing and financing activities of the discontinuing operation during the current financial reporting period.

When an enterprise disposes of assets or settles liabilities, attributable to a discontinuing operation or enters into binding agreements for sale of such assets or the settlement of such liabilities, it should include, in its financial statements, the following information when the events occur:

- For any gain or loss that is recognised on the disposal of assets or settlement
 of liabilities attributable to the discontinuing operation, (a) the amount of the pre-tax
 gain or loss and (b) income tax expenses relating to the gain or loss, and
- 2. The net selling price or range of prices (which is after deduction of expected disposal costs) of those net assets for which the enterprise has entered into one or more binding sale agreements, the expected timing of receipt of those cash flows and the carrying amount of those net assets on the balance sheet date.

The required disclosures may be made either in the notes to the financial statements or on the face of the financial statements except that the disclosure of the amount of the pre-tax gain or loss recognised on the disposal of assets or settlement of liabilities attributable to the discontinuing operation must be shown on the face of the statement of profit and loss. However, a discontinuing operation should be treated as an extraordinary item. The standard also requires disclosure in interim financial report.

AS-24 is recommendatory in nature at present.

AS-25: Interim Financial Reporting

The standard prescribes the minimum content of an interim financial report and the principles for recognition and measurement in the financial statements for an interim period. It states that an interim period is a financial reporting period shorter than a full financial year. It also states that interim financial report means a financial report containing either a complete set of financial statements or a set of condensed financial statements.

Regarding disclosure, an enterprise must include the following minimum information, in the notes to its interim financial statements, if material and if no disclosure is made in the interim financial report:

- A statement that the same accounting policies are adopted in the interim financial statements as those adopted in the most recent annual financial statements, or, if those policies have been changed, a description of the nature and effect of the change;
 - 2. Explanatory comments about the seasonality of interim operations;
- 3. The nature and amount of items affecting assets, liabilities, equity, net income, or cash flows that are unusual because of their nature, size, or incidence;
- 4. The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year or changes in estimates of amounts reported in prior financial years, if those changes have a material effect in the current interim period;
- 5. Issuances, buy-backs, repayments and restructuring of debt, equity and potential equity shares;
- Dividends, aggregate or per share (in absolute or percentage terms) separately for equity shares and other shares;
- Segment revenue, capital employed and result for business segments or geographical segments, whichever is the enterprise's primary basis of segment reporting;

- 8. The effect of changes in the composition of the enterprise during the interim period, such as amalgamations, acquisition or disposal of subsidiaries and long-term investments, restructurings, and discontinuing operations; and
- Material changes in contingent liabilities since the last annual balance sheet date.

With effect from the accounting year commencing on or after 1.4.2002, it was made mandatory for all enterprises.

AS-26 : Intangible Assets

The standard deals with the accounting treatment for intangible assets that are not dealt with specifically in another accounting standard. It requires an enterprise to recognise an intangible asset subject to fulfilment of certain conditions and specifies how to measure the carrying amount of intangible assets and disclose them.

The standard requires the following general disclosures:

- 1. The useful lives or the amortisation rates used;
- 2. The amortisation methods used;
- The gross carrying amount and the accumulated amortisation at the beginning and end of the period; and
- 4. A reconciliation of the carrying amount at the beginning and end of the period showing:
- (a) additions, indicating separately those from internal development and through amalgamation;
 - (b) retirements and disposals;
- (c) impairment losses recognised in the statement of profit and loss, if any, during the period;
- (d) impairment losses reserved in the statement of profit and loss, if any, during the period;
 - (e) amortisation recognised during the period; and
 - (f) other changes in the carrying amount during the period.

The financial statements should disclose the above for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets. In addition, the financial statements should also contain the following *specific disclosures*:

- 1. If an intangible asset is amortised over more than 10 years, the reasons why it is assumed that the useful life of an intangible asset will exceed 10 years from the date when the asset is available for use:
- A description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;
- The existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and
 - 4. The amount of commitments for the acquisition of the intangible assets.

With effect from the accounting year commencing on or after 1.4.2003, it was made mandatory in respect of (a) listed companies or companies whose securities are listed, or are going to be listed, on a recognised stock exchange in India; and (b) all other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 erore.

AS-27: Financial Reporting of Interests in Joint Venture

The objective of this standard is to prescribe principles and procedures for accounting for interests in joint ventures and reporting of joint venture assets, liabilities, income and expenses in the financial statements of venturers and investors.

According to the standard, a venturer (an enterprise) has to disclose the following information in its separate financial statements and in consolidated financial statements:

- 1. The aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:
- (a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been jointly with other venturers;
- (b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and
- (c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.
- 2. The aggregate amount of the following commitments in relation to its interest in joint ventures separately from other commitments:
- (a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

- (b) its share of the capital commitments of the joint venturers themselves.
- A list of all joint ventures and description of interests in significant joint ventures; the proportion of ownership interest, name and country of incorporation or residence in respect of a jointly controlled entities; and
- 4. The aggregate amounts of the each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

With effect from the accounting year commencing on or after 1.4.2002, it was made mandatory for all enterprises.

AS-28: Impairment of Assets

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

The standard should be applied in accounting for the impairment of all assets, other than the following assets:

- 1. Inventories (AS-2: Valuation of Inventories);
- 2. Assets arising from construction contracts (AS-7: Accounting for Construction Contracts);
- 3. Financial assets, including investments that are included in the scope of AS-13: Accounting for Investments; and
 - 4. Deferred tax assets (AS-22 : Accounting for Taxes on Income).

Disclosure requirements of an enterprise under AS-28

- 1. For each class of assets, the financial statements should disclose the following:
- (a) The amount of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are included;
- (b) The amount of reversals of impairment losses recognised in the statement of profit and loss during the period and the line item(s) of the statement of profit and loss in which those impairment losses are reversed;

- (c) The amount of impairment losses recognised directly against revaluation surplus during the period; and
- (d) The amount of reversals of impairment losses recognised directly in revaluation surplus during the period.
- 2. An enterprise that applies AS-17, Segment Reporting, should disclose the following for each reportable segment based on an enterprises's primary format:
- (a) The amount of impairment losses recognised in the statement of profit and loss and directly against revaluation surplus during the period; and
- (b) The amount of reversals of impairment losses recognised in the statement of profit and loss and directly in revaluation surplus during the period.
- 3. If an impairment loss for an individual asset or a cash-generating unit is recognised or reversed during the period and is material to the financial statements of the reporting enterprise as a whole, an enterprise should disclose the following:
- (a) The events and circumstances that led to the recognition or reversal of the impairment loss;
 - (b) The amount of impairment loss recognised or reversed;
 - (c) For an individual asset:
 - (i) the nature of the asset; and
- (ii) the reportable segment to which the asset belongs, based on an enterprise's primary format (as defined in AS-17: Segment Reporting);
 - (d) For a cash-generating unit:
- (i) a description of the cash-generating unit (such as whether it is a product line, a plant, a business operation, a geographical area, a reportable segment as defined in AS-17 or other);
- (ii) the amount of the impairment loss recognised or reversed by a class of assets and by reportable segment based on the enterprise's primary format (as defined by AS-17); and
- (iii) if the aggregation of assets for identifying the cash-generating unit has changed since the previous estimate of the cash-generating unit's recoverable amount (if any), the enterprise should describe the current and former way of aggregating assets and the reasons for changing the way the cash-generating unit is identified;
- (e) Whether the recoverable amount of the asset (c\u00e4sh-generating unit) is its net selling price or its value in use;

- (f) If recoverable amount is net selling price, the basis used to determine net selling price (such as whether selling price was determined by reference to an active market or in some other way); and
- (g) If recoverable amount is value in use, the discount rate(s) used in the current estimate and previous estimate (if any) of value is use.
- 4. If impairment losses recognised (reversed) during the period are material in aggregate to the financial statements of the reporting enterprise as a whole, an enterprise should disclose a brief description of the following:
- (a) the main classes of assets affected by impairment losses (reversals of impairment losses) for which no information is disclosed under the item no. 3; and
- (b) the main events and circumstances that led to the recognition (reversal) of these impairment losses for which no information is disclosed under the item no. 3.

With effect from the accounting year commencing on or after 1.4.2004, it would be mandatory in respect of (a) enterprises whose equity or debt securities are listed on a recognised stock exchange in India, and enterprises that are in the process of issuing equity or debt securities that will be listed on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard; and (b) all other commercial, industrial and business reporting enterprises, whose turnover for the accounting period exceeds Rs.50 crore.

AS-28 would be mandatory w. c. f. the accounting year commencing on or after 1.4.2005 in respect of all other enterprises.

AS-29: Provisions, Contingent Liabilities and Contingent Assets

The objective of AS-29 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions and contingent liabilities and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount. The objective of this Statement is also to lay down appropriate accounting for contingent assets.

AS-29 is applicable under the following situations:

- This Standard should be applied in accounting for provisions and contingent liabilities and in dealing with contingent assets, except:
 - a. those resulting from financial instruments that are carried at fair value;
 - b. those resulting from executory contracts;
 - c. those arising in insurance enterprises from contracts with policy-holders; and

- d. those covered by another Accounting Standard.
- This Standard applies to financial instruments (including guarantees) that are not carried at fair value.
- 3. Executory contracts are contracts under which party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.
- 4. This Standard applies to provisions, contingent liabilities and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.
- 5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Statement instead of this Statement. For example, certain types of provisions are also addressed in Accounting Standards on:
 - a. construction contracts (AS 7, Construction Contracts);
 - b. taxes on income (AS 22, Accounting for Taxes on Income);
 - c. leases (AS 19, Leases); and
- d. retirement benefits (AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).
- 6. Some amounts treated as provisions may relate to the recognition of revenue, for examples where an enterprise gives guarantees in exchange for a fee. This Statement does not address the recognition of revenue. AS 9, Revenue Recognition, identifies the circumstances in which revenue is recognised and provides practical guidance on the application of the recognition criteria. This Statement does not change the requirements of AS 9.
- 7. This Statement defines provisions as liabilities, which can be measured only by using a substantial degree of estimation. The term 'provision' is also used in the context of items such as depreciation, impairment of assets and doubtful debts: these are adjustments to the carrying amounts of assets and are not addressed in this Statement.
- 8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Statement. Accordingly, this Statement neither prohibits nor requires capitalisation of the costs recognised when a provision is made.
- 9. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Statement. Accordingly, this Statement neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

The major disclosure requirements of an enterprise under AS-29

- 1. For each class of provision, an enterprise should disclose the following:
- a. the carrying amount at the beginning and end of the period;
- b. Additional provisions made in the period, including increases to existing provisions;
- c, amount used (i.e. incurred and charged against the provision) during the period; and
 - d. unused amounts reversed during the period.
 - 2. An enterprise should disclose the following for each class of provision:
- a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;
- b. an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events; and
- c. the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.
- 3. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:
 - a. an estimate of its financial effect,
 - b. an indication of the uncertainties relating to any outflow; and
 - c. the possibility of any reimbursement.

With effect from the accounting year commencing on or after 1.4.2004, it was made mandatory barring a few circumstances.

1.6 Disclosure in Company Accounts as per SEBI Guidelines

Stock exchanges have a vital role in the development of capital market for the benefit of the corporate sector. At the same time, they exert influence on the reporting practices of companies with a view to safeguarding the interest of present and potential investors through the compliance of Listing Agreement on the admission of securities for listing. The listing agreement is the most influential aspect of stock exchange regulation as far as the financial reporting is concerned. It aims at securing a regular supply of information

to investors and others, and at specifying the information, which must be supplied by a company. It also ensures consistency of company financial reporting requiring the disclosure of reasons for deviations from an existing policy. Moreover, according to the Agreement Form, each company is required to publish in a form, approved by the stock exchange, periodical interim statement, total turnover, gross profit, depreciation, net profit, etc. Thus, the role of stock exchange, as a regulatory body, in corporate accounting is essentially very important.

The Securities and Exchange Board of India (SEBI) came into existence in 1992 as an exclusive controlling and regulatory body of Indian capital market. It has brought a new dimension in the field of securities, transactions in India. In the meantime, it has taken a number of steps in order to discharge the responsibility of regulating both the primary market (initial issue of securities) and secondary market (dealing with securities in the stock exchanges) with a view to bringing uniformity through the compliance of its guidelines in the matter of financial reporting practices by the companies in the interests of both the present and potential investors.

After the abolition of office of the Controller of Capital Issues (CCI), the SEBI has got the power to vet the prospectus of the companies. Thus, if the companies do not comply with the SEBI guidelines in respect of disclosure, their prospectuses inviting subscription will not be vetted, and they will not be able to issue shares. According to existing guideline, the SEBI requires that specific disclosures be made about NAV (net asset value) of the company, and adequate justification is given for arriving at issue price of shares. The SEBI guidelines cover, however, a wide variety of subjects like issue of shares and debentures, preferential allotment, promoters' contribution, free pricing, underwriting, issue of bonus shares, etc. But its role as a regulator is also significant. It directly regulates the disclosure to be made by the companies while vetting their prospectus. It also indirectly regulates corporate accounting, as through Listing Agreement of Stock Exchanges it requires the publication of unaudited half-yearly working results, proper and adequate disclosures therein, transparency in investors' transactions and so on.

In the recent past, the role of SEBI has improved a lot in issuing two most important guidelines in the matter of corporate accounting and disclosure for the interests of both present and potential investors in particular and harmonising diverse accounting practices of the companies in general. They are:

(a) Mandatory preparation and inclusion of cash flow statement (as defined in AS-3) as a part of financial statements for (i) listed companies or companies whose shares

and debentures are in the process of enlisting on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard; and (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

- (b) A new clause 49 was incorporated in the Listing Agreement on the 'Report on Corporate Governance' as a part of Directors' Report in the annual reports of companies. The following are the list of items as given in Annexure 2 to clause 49 to be included in the Report on Corporate Governance:
 - 1. A brief statement on company's philosophy on code of governance,
- 2. Board of Directors—its composition and functioning, number of meetings held, etc.
 - 3. Audit Committee-terms of reference, composition and meetings.
- 4. Remuneration Committee—terms of reference, composition, remuneration policy, meetings, etc.
- 5. Shareholders' Committee—shareholders' complaints received, suitable action taken, pending share transfers, etc.
 - 6. General Body Meetings.
- 7. Disclosures—significant related party transactions of the company of material nature with its promoters, directors or management and details of non-compliance by the company, i.e., penaltics, fines, strictures imposed on the company by SEBI or Stock Exchange or any statutory authority, on any matter related to capital market, during the last 3 years.
- 8. Means of communication—half-yearly and quarterly results to shareholders, selected newspapers for publication, web site used, etc.
 - 9. General shareholders' information.

The Corporate Governance Report is required to be certified by the auditor of the company.

1.7 Summary

Proper and adequate disclosure of information through preparation and presentation of financial and non-financial statements, charts, diagrams, etc. is the need of the hour not only in the interest of a wide variety of users for taking right decisions but also in the

interest of the companies themselves in the matter of compliance of disclosure requirements as required by the Companies Act, 1956, Indian Accounting Standards and SEBI guidelines. The Companies Act 1956, the Council of the ICAI and SEBI, prominent regulatory bodies, have been playing a remarkable role on the development of corporate accounting and reporting with a view to harmonising diverse accounting and reporting practices in India through the legal framework, standards and guidelines respectively. At present, many Indian companies have started to comply with the financial disclosure requirements that the regulators prescribed so that the users of financial information can take potentially useful economic decisions.

1.8 Exercises

Problem 1:

A company finds that the stock as on March 31, 2004 had included twice an item whose cost was Rs.18,900. State the treatment in the final accounts for the year ending on March 31, 2005.

Answer: As per AS-3, it is prior period item, which requires rectification in stock valuation. It is necessary to deduct Rs.18,900 from opening stock in the profit and loss account for the year ending on March 31, 2005. Also it is necessary to charge Rs.18,900 as prior period adjustment in the profit and loss account below the line. Moreover, AS-3 requires separate disclosure of Prior Period Items, which may be shown either below the line or above the line.

Problem 2:

Apex Ltd. estimated 3% bad debts while preparing final accounts for the year ending on March 31, 2005. Accordingly, provision for bad and doubtful debts was made. However, it appears in the next accounting year that some dues from customers are still lying uncollected. The management feels that an additional 35% provision is necessary on such dues. (a) Should such change in estimate be treated as an extraordinary item? (b) Is it prior period item? Discuss.

Answer: (a) and (b)—No. But according to AS-5, material change in current and later periods should be disclosed.

Problem 3:

Gama Ltd. entered into an agreement to sell its land included in the balance sheet at Rs.4 lakh to Beta Ltd for Rs.25 lakh. The agreement was completed on December 31, 2004 with the approval of its Board of Directors but the sale deed was registered on May 26, 2005. Gama Ltd. prepares its annual accounts on March 31, every year. How this event would be dealt with in the annual accounts?

Answer: This is an event occurring after the balance sheet date. Registration of sale deed provides additional information relating to the conditions existing at the balance sheet date. Thus, adjustments to assets are necessary under AS-4 (Contingencies and Events Occurring after the Balance Sheet Date) and should be disclosed under the 'Notes to Accounts' for the year ending on March 31, 2005.

1.9 Questions

- Q.1 What are the objectives of disclosure of information? Are the Indian companies providing information as needed by the users?
- Q.2 What is meant by regulation of corporate accounting and reporting? Why is external regulation essential?
- Q.3 Explain, in brief, the disclosure requirements in the financial statements of the Companies Act, 1956.
- Q.4 What is the necessity of Accounting Standards? Can Accounting Standards remove diverse financial accounting and reporting practices in India?
- Q.5 State the disclosure requirements in the financial statements for the following:
 - (a) Disclosures of Accounting Policies (AS-1)
 - (b) Valuation of Inventories (AS-2)
 - (c) Cash Flow Statements (AS-3)
 - (d) Contingencies and Events Occurring after the Balance Sheet Date (AS-4)
 - (e) Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies (AS-5)
 - (f) Depreciation Accounting (AS-6)
 - (g) Revenue Recognition (AS-9)
 - (h) Accounting for Fixed Assets (AS-10)
 - (i) Accounting for Investments (AS-13)
 - (i) Accounting for Amalgamation (AS-14)
 - (k) Segment Reporting (AS-17)
 - (l) Related Party Disclosure (AS-18)
 - (m) Earnings Per Share (AS-20)
 - (n) Consolidated Financial Statement (AS-21)
 - (o) Interim Financial Reporting (AS-25)
 - (p) Intangible Assets (AS-26)
- Q.6 State the role of SEBI in the context of disclosure of financial information.

1.10 Suggested Readings

- Banerjee, B: Regulation of Corporate Accounting and Reporting in India, World Press Pvt. Ltd.
- 2. The Companies Act, 1956.
- 3. The Institute of Chartered Accountants of India: Accounting Standards.
- 4. The Securities and Exchange Board of India: Guidelines and Regulations.

Unit 2 Structure of Company Accounts

Structure

- 2.0 Objective
- 2.1 Introduction
- 2.2 The Structure of Company Accounts
 - 2.2.1 Profit and Loss Account
 - 2.2.2 Balance Sheet
 - 2.2.3 Cash Flow Statement
 - 2.2.4 Other Statements
- 2.3 Summary
- 2.4 Questions
- 2.5 Suggested Readings

2.0 Objective

By the time you have gone through this unit you will be able to:

- understand as to what constitute the structure of company accounts;
- * know the elements of the structure of company accounts; and
- know the contents of the elements.

2.1 Introduction

Our present society is a civilised one and it has crossed a long path to come to its present state. Human contributions in a number of fields like literature; history, sociology, science and technology including accounting have made this possible. In the ancient agc, there existed some sort of accounting because of the presence of exchange system. Accounting is an ancient art, clearly as old as money itself, because in India, Kautilya (300 B.C.), the Finance Minister of Emperor Chandra Gupta Murya, clearly mentions in his "Arthshastra", the existence and need of accounting. The Indian system of accounting is certainly older and thus, accounting always played a significant role in every stage of civilisation.

The Industrial Revolution in 1760s and the subsequent developments in the socioeconomic condition all over the world made severe impact on trade and business. As a
result, corporate form of business came into existence during mid-eighteenth century
with a separate entity and perpetual existence, limited liability requiring huge amount of
capital for large scale production and major changes in accounting procedures and
reporting practices have taken place as a direct consequence of such changes in form and
nature of business organisation. This accounting procedure developed the contemporary
balance sheet forming part of the financial reporting during the later part of 19th century
but it lacked in uniformity, terminology and classification of items. The form of balance
sheet adopted on voluntary basis in India in 1857. Much improvement has taken place
in corporate financial reporting practices all over the world since the turn of the century
on account of various compelling factors, such as, the expansion and growth of the
company form of business, the enactment of disclosure laws and emergence of accounting
as a recognised profession. At present, it is recognised as a prestigious and important
profession.

After independence in 1947, India followed a mixed economic path of development. This ultimately led to the development of public sector and private sector side by side. Moreover, the emergence of free market economy in India since 1991 made our economy more liberal and the process of disinvestments have been continuing in the public sector undertakings and private sector have been gaining ground in Indian economy and there is strong possibility that they would be the vital economic driver in the long run in our country. But we have democratic government and the sole objective of every democratic government is to maximise the social welfare. Thus, no democratic government should allow the corporate sector to function freely, which is detrimental to the fulfilment of social objective. Thus, regulation of the corporate sector is essential in respect of functioning including accounting to ensure efficient utilisation of the investors' money and compel the management to be accountable to all stakeholders including the government. Keeping an eye over those objectives, the Companies Act, 1956 was passed by the Parliament of independent India in order to regulate the activities of all companies within the framework of law. The Act also suggested the structure of company accounts which is enforceable to all the companies incorporated in India. In the next section, we would discuss about the structure of company accounts.

2.2 The Structure of Company Accounts

At present, every company is required to prepare its final accounts for the year ending on 31st March every year. In preparing final accounts, every company has to prepare its profit and loss account for the year ended 31st March of each year and a balance sheet as at that date. Moreover, it has to prepare cash flow statement and other statements as per disclosure requirements of accounting standards, as prescribed by ICAI with a view to providing information to the users for taking potentially useful economic decisions. The profit and loss account and balance sheet are the two basic financial statements while the cash flow statement and other statements are the supplementary statements whose only necessity is to justify or to explain, what has been disclosed in the basic financial statements, in order to provide proper and adequate information to the users for taking potentially useful economic decisions.

The Companies Act, 1956, prescribed the formats of balance sheet and profit and loss account in Part II and Part I of the Schedule VI respectively. Preparation of profit and loss account and balance sheet should be made as per prescribed formats or as near thereto, as the case may be. But the preparation of cash flow statement should be made in accordance with the provisions of AS-3, which classifies cash flows into cash flow from operating activities, cash flow from investing activities and cash flow from financing activities. Other statements should be prepared to comply with the requirements of disclosure of accounting standards.

In India, the Companies Act, 1956, governs companies. But due to passage of time, changes in socio-economic conditions, development in trade, industry and commerce, contribution of professional institutions to the improvement and development of accounting concepts and practices, liberalisation of economy, requirement of proper and adequate disclosure of information, and above all growing awareness and attitude of the investors and government, the Act has undergone a number of amendments which have great influence on the corporate accounting and reporting practices in India. With a view to satisfying the changing needs of the users, the vertical form of balance sheet was inserted in Part B of Schedule VI of the Companies Act, 1956 (amended in 1979). The companies have now the option to present their balance sheets in either horizontal or vertical form. The vertical form of balance sheet has been gaining ground very fast due to its obvious merits.

The structure of company accounts refers to a set of financial statements that are required to be prepared by every company at the end of each accounting year in accordance with the compliance of Schedule VI of the Companies Act, 1956 and Accounting Standards as recommended by the ICAI and guidelines as prescribed by SEBI. Thus, a set of financial statements consisting of profit and loss account and balance sheet prepared in adherence to the formats of Part II and Part I respectively of Schedule VI of the Companies Act, 1956, and cash flow statement and other statements, as required to be in compliance with the Accounting Standards and SEBI guidelines is known as the structure of company accounts.

Let us explain the format along with contents of each of the elements of the structure of company accounts in the paragraphs that follow.

2.2.1 Profit and Loss Account

The profit and loss account of a company must be prepared in accordance with the requirements of Part II of Schedule VI of the Companies Act, 1956. These requirements are as follows:

- The provisions of this Part shall apply to the income and expenditure account referred to in sub-section (2) of section 210 of the Act, in like manner as they apply to a profit and loss account, but subject to modification of reference as specified in that subsection.
- 2. The profit and loss account (a) shall be so made out as clearly to disclose the result of the working of the company during the period covered by the account, and (b) shall disclose every material feature, including credits or receipts and debits or expenses in respect of non-recurring transactions or transactions of an exceptional nature.
- 3. The profit and loss account shall set out the various items relating to the income and expenditure of the company arranged under the most conventional heads; and, in particular, shall disclose the following information in respect of the period covered by the account:
- (i) (a) The turnover, that is, the aggregate amount for which sales are effected by the company, giving the amount of sales for each class separately.
- (b) Commission paid to sole selling agents within the meaning of section 294 of the Act.
 - (c) Commission paid to other selling agents,
 - (d) Brokerage and discount on sales, other than the usual trade discounts.
 - (ii) (a) In case of manufacturing companies:
- 1. The value of raw materials consumed, giving item-wise break-up and indicating the quantities thereof. In this break-up, as far as possible, all important basic raw

materials shall be shown as separate items. The intermediates or components procured from other manufacturers may, if their list is too large to be included in the break-up, be grouped under the suitable headings without mentioning the quantities, provided all those items, which in value individually account for 10% or more of the total value of the raw materials consumed, shall be shown as separate and distinct items with quantities thereof in the break-up.

- The opening and closing stocks of goods produced, giving break-up in respect of each class of goods and indicating the quantities thereof.
- (b) In the case of trading companies, the purchases made and the opening and closing stocks, giving break-up in respect of each class of goods traded in by the company and indicating the quantities thereof.
- (c) In the case of companies rendering or supplying services, the gross income, derived from services rendered or supplied.
- (d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements therein if the total amounts are shown in respect of the opening and closing stocks, purchases, sales and consumption of raw material with value and quantitative break-up and the gross income from services rendered is shown.
 - (e) In the case of other companies, the gross income derived under different heads.
- (iii) In the case of all concerns having work-in-progress, the amounts for which such works have been completed at the commencement and at the end of the accounting period.
- (iv) The amount provided for depreciation, renewals and diminution in the value of fixed assets. If such provision is not made by means of a depreciation charge, the method adopted in making such provision. If no provisions is made for depreciation, the fact that no provision has been made shall be stated and the quantum of arrears of depreciation computed in accordance with section 205(2) of the Act shall be disclosed by way of note.
- (v) The amount of interest on the company's debentures and other loans, that is to say, loans for fixed period, stating separately the amount of interest, if any, paid or payable to the managing director and the manager, if any.
- (vi) The amount of charge for Indian Income Tax and other Indian taxation on profits, including, where practicable, with Indian income tax, any taxation imposed elsewhere to the extent of the relief, if any, from Indian income tax and distinguishing, where practicable, between income tax and other taxes.

- (vii) The amounts reserved for :
 - (a) repayment of share capital; and (b) repayment of loans.
- (viii) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserves, but not including provisions made to meet any specific liability, contingency, or commitment known to exist at the date as at which the balance sheet is made up.
 - (b) The aggregate, if material, of any amounts withdrawn from such reserves.
- (ix) (a) The aggregate, if material, of the amounts set aside to provisions made for meeting specific liabilities, contingencies, or commitments.
- (b) The aggregate, if material, of the amounts withdrawn from such provisions, as on longer period required.
 - (x) Expenditure incurred on each of the following items, separately for each item:
 - (a) Consumption of stores and spare parts.
 - (b) Power and fuel.
 - (c) Rent.
 - (d) Repairs to buildings.
 - (e) Repairs to machinery.
 - (f) (1) Salaries, wages and bonus.
 - (2) Contribution to provident and other funds.
- (3) Workmen and staff welfare expenses to the extent not adjusted from any previous provision or reserve.
 - (g) Insurance.
 - (h) Rates and taxes, excluding taxes on income.
- (i) Miscellaneous expenses, provided that any item under which the expenses exceed 1% of the total revenue of the company or Rs.5,000, whichever is higher, shall be shown as a separate and distinct item against an appropriate account head in the profit and loss account and shall not be combined with any other item to be shown under "Miscellaneous Expenses".
- (xi) (a) The amount of income from investments distinguishing between trade investments and other investments.
 - (b) Other income by way of interest, specifying the nature of income.
- (c) The amount of income tax deducted if the gross income is stated under subparagraphs (a) and (b) above.

- (xii) (a) Profits or loss on investments showing distinctly the extent of the profits earned or losses incurred on account of membership of a partnership firm, to the extent not adjusted from any previous provision or reserve.
- (b) Profits or losses in respect of transactions of a kind not usually undertaken by the company or undertaken in circumstances of an exceptional or non-recurring nature, if material in amount.
 - (c) Miscellaneous income.
 - (xiii) (a) Dividend from subsidiary companies.
 - (c) Provision for losses of subsidiary companies.
- (xiv) The aggregate amount of dividends paid or proposed, and stating where such amounts are subject to deduction of income tax or not. Presently no tax is to be deducted from dividend, rather corporate dividend tax has to be paid on dividends.
- (xv) Amount, if material, by which any items shown in the profit and loss account are affected by any change in the basis of accounting.
- 4. The profit and loss account shall also contain or give by way of note detailed information, showing separately the following payments provided or made during the financial year to the directors (including managing directors) or manager, if any, by the company, the subsidiaries of the company and any other persons:
- (i) managerial remuneration under section 198 of the Act paid or payable during the financial year to the directors (including managing directors) or manager, if any;
- (ii) other allowances and commission including guarantee commission (details to be given);
- (iii) any other perquisites or benefits in cash or in kind (stating approximately money value where practicable);
 - (iv) Pensions, etc. :
 - (a) pensions,
 - (b) gratuities,
- (c) payments from provident funds, in excess of own subscriptions and interest thereon,
 - (d) compensation for loss of office,
 - (e) consideration in connection with retirement from office.

- 4A. The profit and loss account shall contain or give by way of note a statement showing the computation of net profits in accordance with section 349 of the Act with the relevant details of the calculation of the commissions payable by way of percentage of such profits to the directors (including managing directors) or manager, if any.
- 4B. The profit and loss account shall further contain or give by way of note detailed information in regard to amounts paid to the auditor, whether as fees, expenses or otherwise for services rendered:
 - (a) as auditor; and,
 - (b) as adviser in any other capacity in respect of:
 - (i) taxation matter,
 - (ii) company law matter,
 - (iii) management services; and
 - (c) in any other manner.

[The ICAI has stated, in its Statement styled "Payment to Auditors for Other Services", that the remuneration to the auditor for other services should be classified as follows:

- 1. for tax representation;
- 2. for company law matters;
- 3. for management services;
- 4. for internal auditing; and
- 5. for other services.]
- 4C. In the case of manufacturing companies, the profit and loss account shall also contain by way of a note, in respect of each class of goods manufactured, detailed quantitative information in regard to the following:
 - (a) the licensed capacity (where licence is in force);
 - (b) the installed capacity; and
 - (c) the actual production.
- 4D. The profit and loss account shall also contain by way of a note the following information, namely:
- (a) value of imports calculated on C.I.F. basis by the company during the financial year in respect of:
 - (i) raw materials;
 - (ii) components and spare parts;
 - (iii) capital goods;

- (b) expenditure in foreign currency during the financial year on account of royalty, know-how, professional consultation fees, interest, and other matters;
- (c) value of all imported raw materials, spare parts and components consumed during the financial year and the value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each of the total consumption;
- (d) the amount remitted during the year in foreign currencies on account of dividends, with a specific mention of the number of non-resident shareholders, the number of shares held by them on which the dividends were due and the year to which the dividends related;
 - (e) carnings in foreign exchange classified under the following heads, namely:
 - (i) export of goods calculated on F.O.B. basis;
 - (ii) royalty, know-how, professional and consultation fees;
 - (iii) interest and dividend;
 - (iv) other income indicating the nature thereof.
- 5. The Central Government may direct that a company shall not be obliged to show the amount set aside to provisions other than those relating to depreciation, renewal or diminution in value of assets, if the Central Government is satisfied that the information should not be disclosed in the public interest and would prejudice the company, but subject to the condition that in any heading stating an amount arrived at after taking into account the amount set aside as such, the provision shall be so framed or marked as to indicate that fact.
- 6. (a) Except in the case of the first profit and loss account laid before the company after the commencement of the Act, the corresponding amount for the immediately preceding financial year for all items shown in the profit and loss account shall also be given in the profit and loss account.
- (b) The requirement in sub-clause (1) shall, in the case of companies preparing quarterly or half-yearly accounts, relate to the profit and loss account for the period ended on the corresponding date of the previous year.

Note: Profit and loss account should contain the figures of the previous accounting year along with the figures of the current accounting year.

2.2.2 Balance Sheet

Every company is required to prepare a balance sheet at the end of each accounting year under section 210 of the Act. Section 211 requires the balance sheet to be prepared

in the prescribed form. This provision is, however, not applicable to banking, insurance, electricity and other companies governed by special Acts. The Central Government has also the power to exempt any class of companies from compliance with the requirement of the prescribed form if it deems to be public interest. The objective of prescribing the form is to elicit proper information from the company so as to give a 'true and fair' view of the state of the company's affairs. As a matter of fact both window dressing and creating secret reserves will be considered against the provisions of section 211. In order to give a true and fair view of the state of affairs of a company it is necessary

- (i) that the information required by law (as specified in Schedule VI to the Act and section 212 as regards subsidiary companies) should be disclosed; and
 - (ii) that the same be disclosed in the manner required.

Part I of Schedule VI gives the prescribed form of a company's balance sheet along with main contents and its sub-contents. The Act permits the presentation of balance sheet both in horizontal and vertical forms. Vertical form of balance sheet over the horizontal form has been gaining ground for its obvious merits and has been used by many companies.

It may be noted that if information required to be given under any of the items or subitems in the prescribed form cannot be conveniently given due to lack of space, it may be given in a separate schedule or schedules. Such schedules will be annexed to and form part of the balance sheet.

Note: Balance sheet should contain the figures of the previous accounting year along with the figures of the current accounting year.

2.2.3 Cash Flow Statement

Presently, cash flow statement is much popular over the funds flow statement because the investors in particulars and the other information seekers in general are greatly interested in cash and cash equivalents generating ability of the companies than the funds generating ability. Cash flows are inflows and outflows of cash and cash equivalents while cash equivalents are short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value. However, AS-3 requires the preparation and inclusion of cash flow statement as an integral part of annual accounts with effect from the accounting year commencing on or after 1.4.2001 in respect of:

- (a) listed company or companies whose shares and debentures are in the process of enlisting on a recognised stock exchange in India;
- (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

AS-3 requires the cash flow statement should report cash flows during the period classified by operating, investing and financing activities. An enterprise presents its cash flows from operating, investing and financing activities in a manner, which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities. Now, we would define classified activities as follows:

- (a) Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
- (b) Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.
- (c) Financing activities are activities that result in changes in the size and composition of the borrowers' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

2.2.4 Other Statements

The role of other statements which are prepared to comply with the requirements of the Companies Act, 1956, Accounting Standards prescribed by the ICAI and SEBI guidelines, is no longer insignificant because their preparation and inclusion in final accounts is a must to make the basic financial statements justifiable to the extent practicable and to exhibit a true and fair view of the profit or loss of the company for the financial year and to give a true and fair view of the state of affairs of the company as at the end of the financial year. Thus, other supplementary statements added to the basic financial statement are the part and parcel of final accounts and may be argued as the part of the structure of the company accounts.

2.3 Summary

The Companies Act, 1956 has a great contribution to the development of the structure of company accounts in India. Changes in socio-economic conditions, need of the users for qualitative information, and above all, accountability of the corporate directors and managers compelled the government to make several amendments to the Act suitably and also encourage the ICAI and SEBI to come forward with environmentally suitable accounting standards and guidelines. This made it possible to get the present structure of company accounts, which is enforceable and indispensable to the Indian corporate houses.

2.4 Questions

- Q.1 What constitute the structure of company accounts in India? Do you think the inclusion or exclusion of any other statements to the final accounts in the context of the Companies Act, 1956, Accounting Standards and SEBI guidelines?
- Q.2 What are the contents of the profit and loss account of a company as per legal requirements?
- Q.3. How is a company balance sheet presented? Explain the situations where secondary financial statements are added to basic financial statements?
- Q.4 Why is traditional cash flow statement not acceptable to the users? Can cash flow statement and other statements be avoided? If not, why?
- Q.5 Explain, in brief, how does the structure of company accounts gets its present shape.

2.5 Suggested Readings

- Schedule VI of the Indian Companies Act, 1956.
- Banerjee, B: Regulation of Corporate Accounting and Reporting in India, World Press Pvt. Ltd.
- 3. The Institute of Chartered Accountants of India: Accounting Standards.
- 4. The Securities and Exchange Board of India: Guidelines and Regulations.

Unit 3 Valuation of Goodwill and Shares

Structure

- 3.0 Objective
- 3.1 Introduction
- 3.2 Meaning of goodwill
- 3.3 Types of goodwill
 - 3.3.1 Purchased goodwill
 - 3.3.2 Non-purchased goodwill
- 3.4 Factors contributing to goodwill
- 3.5 Need for valuation of goodwill
- 3.6 Methods for valuation of goodwill
 - 3.6.1 Super Profit Method
 - 3.6.2 Capitalisation Method
 - 3.6.3 Annuity Method
- 3.7 Capital Employed
 - 3.7.1 Long Term Fund Approach
 - 3.7.2 Equity Approach
- 3.8 Future Maintainable Profit
- 3.9 Normal Rate of Return
- 3.10 Need for Valuation of Shares
- 3.11 Methods
 - 3.11.1 Net Asset Method
 - 3.11.2 Yield Method
- 3.12 Preference Shareholders' claim
- 3.13 Fair Value of share
- 3.14 Summary
- 3.15 Exercises
- 3.16 Questions
- 3.17 Suggested Readings

3.0 Objective

By the time you have gone through this unit you will be able to :

- * know the meaning of goodwill, its types and the factors affecting it;
- * explain the need of valuation and methods of valuation;
- explain why is valuation of shares necessary and the methods of valuation.

3.1 Introduction

Goodwill is an intangible asset but not fictitious. Since it is an intangible asset, it cannot be used as tangible assets like land & building, plant & machinery, furniture & fittings; but like other tangible assets it contributes to the profit earning capacity of the business. Again, goodwill is a valuable asset if the business is profitable; it is value less if the business is a losing one. When a business is able to earn profits at a rate higher than its similar counterpart, the business is said to possess goodwill.

3.2 Meaning of Goodwill

Goodwill is the value of the reputation, connection or other advantage of the business judged in respect of its capacity to bring in, unaided, profits. It is that attractive force which brings customers into the business. Again, it is the value of excess earning power of a firm. Actually, it is the present value of the excess anticipated future earnings of an enterprise. Thus, goodwill may be defined as the value of the reputation of a business in respect of profits expected in future over and above the normal level of profits earned by undertakings belonging to the same class of business.

SSAP-22, UK 'Accounting Standard on Accounting for Goodwill' defines the term goodwill as follows:

"Goodwill is the difference between the value of a business as a whole and the aggregate of the fair values of its separable net assets." Separable net assets are those assets, which can be identified and sold (or discarded) separately without necessarily disposing of the business as a whole. They include the identifiable intangibles. Fair value is the amount for which an individual asset (or liability) could be exchanged in an arm's length transaction.

3.3 Types of Goodwill

In business, there are two types of goodwill, namely, purchased goodwill and inherent or non-purchased goodwill. Different types of goodwill are discussed in the paragraphs that follow.

3.3.1 Purchased goodwill

It may arise when a business purchases another business. Purchased goodwill is the excess of the purchase consideration over and above the fair value of the separable net assets acquired with an expectation of better future prospects of the entity as a whole. It must not exist in a business except by business purchase. Conventionally, only purchased goodwill is recognised in accounting.

3.3.2 Non-purchased goodwill

Internally generated goodwill is known as non-purchased or inherent goodwill. It arises when a business over the years generates its own goodwill. It is not shown in the balance sheet.

3.4 Factors Contributing to Goodwill

In valuing goodwill following factors are to be taken into account :

Purchased and non-purchased goodwill	Purchased goodwill only
1. Superior management team	1. Market dominance
2. Outstanding sales manager or organisation	 Economics of scale (production, advertising, distribution, research, management)
Weakness in the management of a competitor	 Cost savings (employing technology, transaction costs, co-ordinating activities, stock-holding savings)
4. Effective advertising	 Cost of financing (reduction in cost of borrowings and lender's risk)
5. Secret or patented manufacturing	 Fiscal advantages (tax losses investment credits, government incentives)

Purchased and non-purchased goodwill		
6. Good labour relations	6. Strong liquid resources	
7. Outstanding credit rating	7. Preliminary expense savings	
Top flight training programme for employees	8. Ability to guarantee suppliers	
9. Good public 'image'	9. Ability to guarantee market	
10. Unfavourable development in operation of a competitor	10. Investors' collective evaluation of political, economic or social position	
11. Favourable association with another company	11. Opinions of acquirer's directors as to future policy of acquirer	
12. Strategic location	12. Costs of acquisition	
13. Discovery of talents or resources		
14. Favourable tax conditions		
15. Favourable government regulations		
16. Favourable attitudes of customers		
17. Excellent reputation of quality and		
reliability of products		
18. Number of outlets for products		
19. Number of service locations for products	tine differential sensi Sensi Ameri	
20. Favourable agency agreements		
21. Established list of customers		
22. Established licence to trade		
23. Experience work-force		

3.5 Need for Valuation of Goodwill

24. Good relations with suppliers25. Superior pension fund resources

In case of a joint stock company, the need for valuation of goodwill arises in the following circumstances:

(1) When the business of a company is taken over by another company for the purpose of amalgamation or absorption.

- (2) When the shares of the company are quoted on the stock exchange and their valuation is to be made for the purposes of wealth tax, gift tax, etc.
 - (3) When the business of a company is being taken over by the government,
- (4) When a person (or a company) wants to buy a large block of shares of a company (or another company) with a view to exercising control over the management of the company concerned.
- (5) When the management wants to write back goodwill, which it wrote off previously to reduce or eliminate the debit balance in the profit and loss account.

3.6 Methods for Valuation of Goodwill

Generally there are three popular methods for valuation of goodwill. They are:
(1) Super Profit Method; (2) Capitalisation Method and (3) Annuity Method. These may be discussed in the following paragraphs:

3.6.1 Super Profit Method

The excess of average future maintainable profit over the normal profit is known as super profit. In this method, goodwill is taken as the sum of super profit of the future years for which such super profit is expected to be maintained. The elements to be taken into account in determining the value of goodwill are:

- (a) Average future maintainable profit;
- (b) Capital employed;
- (c) Normal rate of return; and
- (d) Number of year(s) for which super profit is expected to be maintained, i.e., number of years' purchase.

Super Profit = Future maintainable profit - (Capital employed x Normal rate of return)

Goodwill = Super profit x Number of year(s) for which super profit can be maintained

Illustration 1:

Capital employed of Venus Ltd. was Rs.20,00,000. Profits for the last 3 years ended March 31, were Rs.2,90,000, Rs.3,00,000 and Rs.3,10,000 respectively. Normal rate of return is 12%. Super profit is expected to be maintained for 4 years.

Determine the value of goodwill.

Solution

Super Profit

Average future maintainable profit [(2,90,000+3,00,000+3,10,000)/3] Rs.3,00,000

Less: Normal return @12% on capital employed

([Rs.20,00,000 × 10%) Rs.2,40,000

Rs.60,000

Value of goodwill = Super profit × No. of years for

which super profit can be maintained

 $= Rs.60,000 \times 4 = Rs.2,40,000$

Illustration 2:

In 2004-05, a company reported a net profit of Rs.1,89,000 after 40% tax. It was found that the profit for the year 2004-05 had included Rs.22,500 for a claim lodged in 2001-02 for which no entry had been passed then. As far as trading conditions are concerned, 2004-05 was a normal year. The company expects to launch a new product in June, 2005. Estimates in this respect are as follows:

	Rs.		
Sales	2,40,000		
Materials, wages, etc.	1,12,500		
Expected increase in fixed expenses	25,000		

Ascertain the value of goodwill of the company it it is calculated at two times the future maintainable profit.

Solution

Valuation of Goodwill

Particulars (1997)	Amour Rs.	Amount Rs.
After tax net profit before launching a new produ-	ct	1,89,000
Less: Claim after tax (22,500 × 60%)		13,500
After tax additional profit from launching a new j	product :	
Sales	2,40,00	0
Less: Materials, wages, etc. 1	,12,500	
Increase in fixed expenses	25,000 1,37,50	0
Additional profit before tax	1,02,50	0
Less: Tax @ 40%	41,00	0 61,500
Future maintainable profit after tax (a)	in less in the	2,37,00
Thus, value of goodwill [(a) × 2]	Tak Links	4,74,000

3.6.2 Capitalisation Method

Under this method, average future maintainable profit is capitalised using normal rate of return to arrive at the value of the firm (including goodwill). Goodwill is taken as the excess of the value of the firm (including goodwill) over the value of capital employed (excluding goodwill) for which goodwill is calculated. In this method the following elements are to be taken into account:

- (a) Average future maintainable profit;
- (b) Capital employed in the business for which goodwill is to be calculated; and
- (c) Normal rate of return in the industry to which the business belongs.

Value of the business = (Average future maintainable profit)/(Normal rate of return)

Value of goodwill = Value of the business - Value of capital employed

Illustration 3:

Capital employed in Venus Company Ltd. is Rs.20,00,000. Average future maintainable profit is Rs.3,00,000. Normal rate of return is 12%. Find out the value of goodwill.

Solution

Value of the business = (Average future maintainable profit)/Normal rate of return = (Rs.3,00,000)/0.12=Rs.25,00,000

Value of goodwill = (Value of the business) - (Value of capital employed) = Rs.(25,00,000 - 20,00,000) = Rs.5,00,000

Illustration 4:

Mr. Gupta is the owner of a medical shop. On March 31, 2004, his capital employed in the business amounted to Rs.5,20,000. He pays Rs.1,500 as monthly salary to a chemist and rent of Rs.6,000 per year. Mr. Roy, landlord and a famous chemist, is interested in buying the business of Mr. Sen. Average annual profit after salary and rent amounts to Rs.41,000. Value of Building owned by the chemist landlord rented to Mr. Sen is Rs.80,000.

If 10% return on capital employed can be considered as fair, what amount of goodwill Mr. Roy should pay?

Solution

Valuation of Goodwill

Particulars Particulars	Amount Rs,	Amount Rs,
(i) Capital Employed:	2 1 37	
Capital introduced by Mr. Gupta		5,20,000
Add: Value of Building	de la companya della companya della companya de la companya della	80,000
THE PARTY OF THE P		6,00,000
(ii) Super Profit : Walliam Stranger of the Company		
Profit after salary and rent		41,000
Add: Expenses no longer required:	dent he	
Salary of the chemist	18,000	
Rent of the shop	6,000	24,000
Less: Normal return on capital employed (6,00,000 × 10%)		65,000
(iii) Value of goodwill (Capitalised value of super profit at 10% = Rs.5,000 × (100/10)		50,000

3.6.3 Annuity Method

This method is the refinement of the super profit method. Super profit is expected to arise usually at the end of each financial year, i.e., at different points of time. In order to find out the value of goodwill, it would be unfair to simply multiply the super profit by the number of years' purchase for which super profit is expected to be earned. So future values of super profit must be discounted using appropriate discount rate (i.e., normal rate of return) with a view to getting present value of super profits. In case of even annual super profit, the *Annuity Formula* can be used suitably for discounting future values of super profit in order to convert them into the present value; or, annual super profit can be multiplied by the sum of present values of the appropriate discount rate to find out the value of goodwill.

Illustration 5:

Super profit of Venus Ltd. Rs.60,000 per year can be maintained for 4 years. Discount rate is 12%. Find the value of goodwill.

Solution

Goodwill (V) = A/I[1 - 1/(1 + i)ⁿ] Where, V=Value of goodwill = (Rs.60,000)/(0.12)[1 - 1/(1 + 0.12)4 A = Average super profit = $Rs.5,00,000 \times [(0.5735)/(1.5735)]$ i = Interest per rupee p.a. = Rs.1,82,237 n = No. of years for which super profit can be maintained

Alternatively, goodwill = Super profit x Sum of present values at 12% for 4 years = Rs.60,000 x 3.0373 = Rs.1,82,238*

*Difference is due to approximation.

3.7 Capital Employed

It is the most important factor in valuation of goodwill because the volume of profit is significant only in relation to the capital used to earn it. Capital employed is dependent on the approach to be adopted. There are two approaches: (1) Long Term Fund Approach and (2) Equity Approach. They are discussed below:

3.7.1 Long Term Fund Approach

Under this approach, capital employed refers to permanent resources used to earn profit. Accordingly, capital employed means 'total assets minus non-trading assets minus fictitious assets minus current liabilities.' Alternatively, capital employed means 'net-worth plus long-term debt.'

3.7.2 Equity Approach

This approach is suitable for the purpose of valuing goodwill of companies where it is essentially the advantage accruing to the shareholders, which has to be evaluated. For this reason only such funds which is attributable to the shareholders is to come into capital employed with a view to giving weightage to *financial leverage* while calculating goodwill. Thus, in valuing goodwill of companies where advantage of financial leverage goes in favour of shareholders, capital employed means 'total assets minus non-trading assets minus fictitious assets minus all outside liabilities including long-term debt.' Alternatively, capital employed means only 'net-worth.' Thus, in valuing goodwill, *equity approach* should be preferred on the ground that use of debt capital at a cheaper rate than that it has earned so that the value of the firm will be maximum.

It is to be remembered that profit is expressed in terms of current prices. So, in order to make fair determination of capital employed, all assets and current liabilities (or, outside liabilities) are to be taken at current prices, because profit is measured at current price. In making so, all fixed assets and inventories are to be taken into account at current prices and the remaining current assets and current liabilities (or, outside liabilities) need not require any valuation as they are already stated at current prices.

Since the capital employed changes over the year, it would be better to have a average capital employed instead of capital employed (i.e., closing capital employed) because average capital employed is the true representative of the capital employed while evaluating goodwill.

3.8 Future Maintainable Profit

Future maintainable profit is the second important factor in determining the value of goodwill. Future maintainable profit is ascertained by taking either simple average or weighted average, as the circumstance demands, of the past profits. Conventionally, profits of last 3 to 5 years are considered. When the past profits do not show any definite trend, simple average is used to ascertain the future maintainable profit. In case of increasing or decreasing trend of the past profits, weighted average is taken in order to ascertain future maintainable profit. However, more weights are assigned to the profit figures of the immediate past years while less weight are given to the profit figures of the furthest past years.

Nevertheless, ascertainment of future maintainable profit requires following adjustments:

- (1) Elimination of non-trading loss due to sale of asset(s), fire, earthquake, flood, strike, lock out, etc. from profit or loss.
- (3) Elimination of non-trading income arising out of sale of asset(s), dividend or interest income, etc. from profit or loss because capital employed consists only of trading assets. But, in case of income received from trading investments, needs no adjustment.
- (4) In case of increase or decrease in the value of fixed assets on account of revaluation, under-charged or over-charged depreciation should be adjusted on the increased or decreased values.
- (5) In case of change in the corporate tax rate, tax charged at old rate should be added back and tax should charge at new rate.

(6) In case of change in accounting policy, profit or loss should be so adjusted to have profit or loss on the basis of uniform accounting policy.

3.9 Normal Rate of Return

Normal rate of return is the third important factor in valuing goodwill. It means the rate of return that will satisfy an ordinary investor (not very reluctant or eager to invest) in the industry concerned. Such a return differs from industry to industry. It comprises of two components:

- (a) Risk-free rate: It is the pure interest rate prevailing in the concerned economy (the rate of return on fixed deposit in bank or government securities may be considered as risk-free rate).
- (b) Risk premium: It is the premium in addition to risk-free rate for taking business risk for the industry to which the company belongs. It is relevant to state that, higher is the business risk, the higher is the normal rate of return. In practice, industry average return is taken as normal rate of return.

Illustration 6:

From the following information, determine:

- (a) Capital employed;
- (b) Average capital employed; and
- (c) Value of goodwill by (i) super profit method (on the basis of 5 years' purchase of average super profit); (ii) capitalisation method; and (iii) annuity method (on the basis of super profit can be maintained for 5 years).

Balance Sheet of Z Ltd. as on March 31, 2005

Liabilities	Amount	Assets	Amount
	Rs.	bend policy monter distriction	Rs.
20,000 Equity Shares of		Goodwill	30,000
Rs. 10 each	2,00,000	Fixed Assets	3,50,000
1,000 9% Preference Shares		Investments	rei bereite
of Rs. 1000 each	1,00,000	(6% Govt. Loan)	45,000
Reserve and Provision		Current Assets	2,00,000
(Provision for taxation		Share-selling commission	10,000
Rs. 20,000)	2,00,000	Discount on issue of	1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1
10% Debentures	90,000	debentures	15,000
Creditors	60,000		S-1000000000000000000000000000000000000
	6,50,000		6,50,000

The current market value of the plant included in fixed assets is Rs.15,000 more. The average profit of the company (after deductions of interest and govt. taxes) is Rs. 68,000. The normal rate of return is 12%. Tax rate is 40%.

Solution as per equity approac	Solution	as per	equity	approach
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(a)	Capital En	ployed		Rs.
300		Assets as per given balance sheet		6,50,000
	Add:	Increase in plant		_15,000
				6,65,000
	Less:	Goodwill	30,000	
		Investments	45,000	
		Share-selling commission	10,000	
		Discount on issue of debentures	<u>15,000</u>	1,00,000
		a Saniega, britis e substituis la		5,65,000
	Less:	10% Debentures	90,000	
		Provision for taxation	20,000	
		Creditors	60,000	1,70,000
	120	ester la propieta de la companya de	daten kan dibal	3,95,000
(b)	Average (Capital Employed		Rs.
	Capital En	mployed as in (a) above		3,95,000
	Less : 1/2	of average trading profit after taxes (65	5,480 x ½)	32,740
				3,62,260
(c)	Valuation	of Goodwill		
	(i) Super	Profit Method:		Rs.
	Averag	ge profit after interest and tax		63,000.00
	Less :	Income from investments after tax (45,	,000 x 6% x 60%)	1,620.00
				66,380.00
	Less :	Under-charged depreciation on increase	ed value of plant,	
	entermine of	say 10%, net of tax (1,500 x 60%)		900.00
	Avera	ge trading profit or future maintainable	profit after taxes	65,480.00
	Less :	Normal return @ 12% on average cap	ital employed	43,471.20
	30000000000000	profit		22,008.80
	Goodwill	= Super profit × No. of years for which	super profit can be	maintained
		$= Rs.22,008.80 \times 5 = Rs.1,10,044$		

(ii) Capitalisation Method:

Goodwill = Capitalised value of net separable assets included in the capital employed minus Capital employed

- = (Average future maintainable profit after taxes)/12% Capital employed
- = (Rs.65,480)/12% Rs.3,95,000
- = Rs.1,50,667

(iii) Annuity Method:

Goodwill = Super profit × Sum of present values at 12% for 5 years = Rs.22,008.80 × 3.6048 = Rs.79,337

Solution as per long-term fund approach

(a)	Capital Employed	Rs.
	Capital employed as per shareholders' fund approach	3,95,000
	Add: 10% Debentures	_90,000
	A Light and I mississed	4,85,000
(b)	Average Capital Employed	Rs.
	Capital employed as in (a) above	4,85,000
	Less: ½ of average profit after taxes	32,740
		4,52,260
(c)	Valuation of Goodwill	
	(i) Super Profit Method:	Rs.
	Average trading profit after taxes as per	
	shareholders' fund approach	65,480.00
	Add-back Debenture interest	9,000.00
	Average trading profit or future maintainable profit after taxes	74,480.00
	Less: Normal return @ 12% on average capital employed	54,271.20
	Super profit	20,208.80

Goodwill = Super profit x No. of years for which super profit can be maintained = $Rs.20,208.80 \times 5 = Rs.1,01,044$

(ii) Capitalisation Method:

Goodwill = (Rs.74,480)/12% — Rs.4,85,00 = Rs.1,35,667

(iii) Annuity Method:

Goodwill = $Rs.20,208.80 \times 3.6048 = Rs.72,849$

3.10 Need for Valuation of Shares

Shares of all public limited companies are not quoted on the stock exchange. Again, shares of private limited companies, in any case, will not be quoted. In case of change of hands of unquoted shares, value of such shares should be ascertained. Moreover, need of valuation of shares arises in the following circumstances:

- (1) Assessments under the estate duty, gift tax, wealth tax, etc.
- (2) Purchase of a block of shares generally involving acquisition of controlling interest in the company.
 - (3) Formulation of schemes of amalgamation, absorption, reconstruction, etc.
- (4) Acquisition of interest of dissenting shareholders under a reconstruction scheme.
- (5) Compensating shareholders on the acquisition of their shares, by the government under a nationalisation scheme.
 - (6) Conversion of preference shares into equity shares.
- (7) Advancing loan on the security of shares.
- (8) Purchase of shares by the employees of the company where the retention of such shares is limited up to the period of their retirement.

3.11 Methods of Valuation of Shares

Basically there are two methods used for valuation of equity shares. They are explained as below:

3.11.1 Net Asset Method:

This method is also known as asset backing method or intrinsic value method or break-up value method or balance sheet method. The essence of this method is the security, safety and asset cover of shares. Under this method, value per equity share is ascertained as follows:

Value per equity share = (Net assets available for equity shares)/(No. of equity shares)

The following important aspects should be considered while arriving at the 'net assets available for equity shares':

(1) A proper value should be placed on the goodwill of the business. Valuation of goodwill should be made using any of the methods, as explained in the preceding

pages. Since non-purchased goodwill is not shown in the balance sheet, it should not be considered at all while calculating the value of capital employed and valuing shares.

- (2) Proper valuation should be made for other intangibles like patents, trademarks, know-how, etc. They should be valued at their current cost. Current cost implies entry price. Again, entry price means the price to be paid by the company if it wants to acquire any asset at its present condition.
- (3) Fictitious assets like debit balance in the profit & loss account, preliminary expenses, discount on debentures, underwriting commission, etc. should not be considered at all and should be excluded as well.
- (4) All tangible fixed assets and non-trading investments should be taken at their market values. In the absence of information relating to the market values of assets, balance sheet values may be taken as the market values.
- (5) Stock of finished goods including stock of raw materials and work-in-progress should valued at cost or market price, whichever is lower.
- (6) Adequate provision for bad and doubtful debts should be made against sundry debtors.
- (7) Bills receivable in hand, prepaid expenses and accrued incomes should be taken at their book values.
- (8) In case of equity shares having same nominal value, but different paid up values, it is advisable to make notional calls on unpaid shares in order to make the partly paid up shares notionally fully paid up. Amount to be realised from notional calls is taken as if cash in hand.
- (9) In case of equity shares having different nominal values and different paid up values, it is advisable to distribute net assets available for equity shareholders before making notional calls among different groups of share in proportion of paid up capital; and then make notional calls on unpaid shares to make them notionally fully paid up.

Following liabilities should be deducted from the total assets arrived at as discussed above, in order to find out the net assets available for equity shareholders:

- (1) All long-term debts including outstanding interest.
- (2) Current liabilities like bank overdraft, sundry creditors, bills payable, outstanding expenses, pre-received incomes or provision for taxation.
 - (3) All liabilities not provided for in the accounts.

- . (4) Preference share capital including arrear and proposed preference dividends, if any.
- (5) When the management of a company wants to know the ex-dividend value per equity share, equity proposed dividend should also be deducted along with other liabilities.

Valuation of shares under net asset method is useful for formulating scheme of amalgamation or when a person (or, a company) wants to acquire a controlling interest in the company. This method is also suitable for those who are risk averse.

Illustration 7:

The following is the summarised Balance Sheet of X Ltd. as on March 31, 2005 :

Rs. Equity Shares of 100 each fully paid 2,00,000 Ch fully paid 1,00,000 Rs. Goodwill Land & Building Plant & Machinery Investment in National	Amount Rs, 10,000 2,10,000
1 Reserve 30,000 Plan Certificates Ind Equalisation Reserve Velfare Fund 15,000 Stock at cost Indexees' Provident Fund Indexes Compensation Indexented by investments Indexerve Savigns A/c 20,000 Plan Certificates Stock at cost Sundry Debtors Bills Receivable Cash at Bank Cash in hand Preliminary Expenses Stock at cost Sundry Debtors Plan Certificates	1,50,000 10,000 90,000 40,000 8,000 1,37,000 10,000
ented by investments) 10,000 Pre 20,000 Reces' Savigns A/c 60,000	

On April 1, 2005 all Preference Shares were redeemed at a premium of 10% out of profits otherwise available for dividend.

You are required to ascertain the value of each Equity Share by Net Asset Method on the basis of the Balance Sheet immediately after redemption of Preference Shares taking into consideration of the following information:

(a) Goodwill is valued at Rs.85,000.

- (b) 10% of Sundry Debtors are to be considered as bad.
- (c) A claim for compensation to an employee has been admitted on April 1, 2005. The amount involving being Rs.5,000.
 - (d) All other assets are to be taken at their book values.

Solution

Net assets available for equity shareholders :	Rs.	Rs.
Total assets as per last balance sheet		6,75,000
Add: Increase in goodwill		75,000
		7,50,000
Less: Decrease in bank balance for redemption		
of preference shares		1,10,000
		6,40,000
Less: Decrease in sundry debtors for bad debt	4,000	
Preliminary expenses	10,000	14,000
Bug at 15 1 graph to the Standard and th		6,26,000
Less: Current liabilities:		
Staff welfare fund*	15,000	
Employees' provident fund	1,40,000	
Claim for compensation to an employee	5,000	
Employees' savings A/c	20,000	SOVICE THE
Provision for taxation	40,000	
Sundry Creditors	50,000	2,70,000
		3,56,000

Value of each share = (Net assets available for equity shares)/Number of shares = Rs.3,56,000/2,000 = Rs.178

3.11.2 Yield Method:

Yield refers to effective rate of return from similar types of investment. Investors are interested in yield of the company and ultimately in dividend. The essence of this method is the return on investment. Hence, the valuation of shares should be based on return on investment of the company concerned. This method is also known as market value method or earning capacity method. Again, this method may be divided

^{*} Staff Welfare Fund is treated as current liability according to conservatism concept.

Market value = [(Company dividend) × (Paid up value per share)]/(Market dividend) In determining the company dividend, average of the immediate past of 3 to 5 years of actual dividend paid by the company may be taken.

This basis of valuation is preferred by investors who invest their funds with speculative motive and who are risk taker and are less interested in asset cover of their shares.

Illustration 8:

From the following information, find out the value of each equity share under yield method:

20,000 12% Preference shares of Rs.10 each fully paid	Rs. 2,00,000
25,000 Equity shares of Rs.10 each fully paid	Rs. 2,50,000
20,000 Equity shares of Rs.10 each, Rs.7.50 paid up	Rs. 1,50,000
Expected profit per year before taxes	Rs. 2,25,000
	The state of the s

Rate of tax: 40%

Transfer to general reserve: 20% of profit after taxes

Normal rate of return on equity capital: 15%

Rate of equity dividends for last 3 years are 14% 13% and 15% respectively.

Similar companies pay dividend @ 12.50% on paid up equity capital.

Solution

On the basis of expected equity dividend (i.e. controlling interest):	Rs.
Expected profit before taxes per year	2,25,000
Less: Taxes @ 40%	90,000
Distributable profit after taxes per year	1,35,000
Less: Transfer to general reserve @ 20%	27,000
Profit available to shareholders	1,08,000
Less: Preference dividend @ 12% on Rs.2,00,000	24,000
Profit available for equity dividend	84,000
Paid up equity capital=(Rs.2,50,000 + Rs.1,50,000) = Rs.4,00,000	

Company expectation= [(Profit available for equity div.) × 100]/(Paid up equity capital) = (Rs.84,000 × 100)/Rs.4,00,000 = 21%

Market expectation, i.e. normal rate of return on equity capital = 15%

into two categories. They are: (1) on the basis of expected dividend and (2) on the basis of actual dividend; and they are discussed in the paragraphs that follow.

On the basis of expected dividend:

This basis of valuation is most suitable to the holders of large block of shares (i.e. controlling interest/majority holding) because they can dictate over the payment of dividend. The formula for determining the market value per equity is:

Market value = [(Company expectation) × (Paid up value per share)]/(Market expectation). Here, company expectation is the rate of dividend/yield expected from the company while the market expectation is the normal rate of dividend/yield from the market.

In view of finding out the recent company yield, it is advisable to take the average of last 3 to 5 years' earnings of the company. Moreover, it requires adjustment of the following aspects:

- (1) Abnormal losses due to fire, theft, burglary, etc. should be eliminated from the figures of profit and loss.
 - (2) Non-trading incomes and losses should be eliminated.
 - (3) Capital profit or loss on account of sale of fixed assets should be eliminated.
- (4) Compensation paid to employees due to accident or voluntary retirement scheme (VRS) should be eliminated.
- (5) Compensation received for acquiring land or property of the company by the government, should be eliminated.
 - (6) Adequate provision for taxation should be made.
- (7) In respect of transfer to general reserve due care should be given to strengthen the future financial condition of the company as per the requirements of the Companies Act, 1956.
 - (8) Preference dividend should be considered.

On the basis of actual dividend:

This basis of valuation is highly suitable to the holders of small block of shares (i.e., non-controlling interest/minority holding) because they cannot dictate over the payment of dividend of the company. As a result, expectation of the minority shareholders should be confined to the payment of actual dividend. The formula for ascertaining the market value per share is:

Market value per share = [Company expectation) x (Paid up value)]/(Market expectation) : Fully paid up = $(21\% \times Rs.10)/15\% = Rs.14.00$

Partly paid up = $(21\% \times Rs.7.50)/15\% = Rs.10.50$

On the basis of actual equity dividend (i.e. non-controlling interest) :

Since the rates of dividend paid are fluctuating during the last 3 years, simple average is suitable in order to find out average company dividend.

Company dividend = (14% + 13% + 15%)/3 = 14%

Market dividend =12.50%

Market value per share = [(Company dividend) × (Paid up value)]/(Market dividend) :

Fully paid up = $(14\% \times Rs.10)/12.50\% = Rs.11.20$

Partly paid up = $(14\% \times Rs.7.50)/12.50\% = Rs.8.40$

3.12 Preference Shareholders' Claim

The claim of Preference Shareholders may be ascertained under the following situations :

- (1) When preference shares have priority as to the payment of capital only (i.e. non-cumulative), then preference shareholders' claim will be limited to paid up capital only.
- (2) When preference shares are redeemable at a premium, then preference shareholders' claim will be paid up capital plus arrear dividend plus premium payable on redemption.
- (3) When preference shares have priority as to the payment of capital and arrear dividend (i.e., cumulative), the preference shareholders' claim will be limited to paid up capital plus arrear dividend.
- (4) When preference shares are participating, then preference shareholders' claim will be paid up capital plus share of surplus of assets, if any, after payment of both preference share capital plus equity share capital.

The question arrear preference dividend does not arise at all in case of non-cumulative preference shares. But when the shares are not specifically mentioned as non-cumulative, they should be considered as cumulative.

Illustration 9:

The following is the Balance Sheet of Union Ltd. as on March 31, 2005:

Liabilities	Amount	Assets	Amount
especial and runose	Rs.	phisils chaps burns to ske	Rs.
6% Preference Shares of	Tellant 39	Fixed Assets	4,10,000
Rs. 10 each fully paid	2,00,000	Current Assets	2,48,000
Equity Shares of Rs. 10	- 30 - 00	Preliminary Expenses	10,000
each fully paid	3,00,000	Discount on debentures	5,000
General Reserve	12,000	Profit & Loss A/c	27,000
Debenture Redemption Fund	18,000	results and make the min	
Investment Fluctuation Fund	10,000		Contract
5% Debentures	50,000	0 当6月39 20日 秦	and the same
Depreciation Fund	20,000	Constitution of the Constitution of	- winer
Sundry Creditors	90,000		
	7,00,000		7,00,000

Current assets included investments of Rs.60,000, market price of which is Rs.64,000. Debtors included in current assets are doubtful to extent of Rs.5,000 for which no provision has been made so far. Stock includes obsolete items of Rs.6,000 and at the end of the year did not include a return of Rs.1,000 though the transaction was properly recorded and posted.

Debenture interest owes for one year and preference dividends are in arrear for two years. Other assets are worth book values.

You are required to find out the value of each equity and preference share under the following circumstances:

- (a) When preference shares have priority both as to the payment of capital and arrear of dividend in the event of liquidation takes place;
- (b) When preference shares have no priority as to the payment of capital and arrear dividend.
- (c) When preference shares have priority as to the payment of capital only; and
- (e) When preference shares have priority as to the payment of arrear dividend only.

Solution

1.	Net Assets available for shareholders:	Rs.	Rs.
То	tal assets as per last balance sheet	mul) male due	7,00,000
Add:	Increase in the value of investments	4,000	
250	Return of goods not included in stock	1,000	5,000
	# Shear		7,05,000
Less:	Depreciation fund	20,000	
	Provision for doubtful debts	5,000	
	Obsolete items of stock	6,000	
	Preliminary expenses	10,000	
	Discount on debenture	5,000	
	Debit balance of profit and loss A/c	27,000	73,000
Re	valued total assets		6,32,000
Less:	Outside liabilities:		
	5% Debentures	50,000	
	Outstanding debenture interest for one year	2,500	
	Sundry creditors	90,000	1,42,500
	**		4,89,500

(a) When preference shares have priority both as to the payment of capital and arrear of dividend (i.e., cumulative preference shares) in the event of liquidation takes place:

		Rs
Net assets available for shares as in (1) above	others and additional at	4,89,500
Less: Preference shareholders' claim:		
Paid up preference share capital	2,00,000	
Arrear dividends for 2 years	24,000	2,24,000
Net assets available for equity shares		2,65,500
Males of such abanes/Not assets available for	aleanay/www.ban.af.ale	

Value of each share=(Net assets available for shares)/number of shares:

Preference share = Rs.2,24,000/20,000 = Rs.11.20

Equity share = Rs.2,65,500/30,000 = Rs.8.85

(b) When preference shares have no priority as to the capital and arrear dividend (i.e., when preference shares are to be treated as equity shares) :

Value of each share (both preference and equity) = Rs. 4,89,500/(30,000 + 20,000) = Rs.9.79

(c) When preference shares have priority as to the payment of capital only (i.e., non-cumulative preference shares):

	KS.
Net assets available for shares as in (1) above	4,89,500
Less: Preference shareholders' claim: Paid up capital only	2,00,000
Net assets available for equity shares	2,89,500
Value of each share :	

Preference share = Rs.2,00,000/20,000 = Rs.10.00

Equity share = Rs.2,89,500/30,000 = Rs.9.65

(d) When preference shares have priority as to the payment of arrear dividend only :

	Ks.
Net assets available for shareholders as in (1) above	4,89,500
Less: Arrear preference dividend	24,000
Net assets available for shares after arrear preference dividend (1)	4,65,500
	A Commence of the Commence of

Distribution of assets as in (1) should be made between preference shares and equity shares in the paid up capital ratio of 2,00,000 : 3,00,000, i.e., in the ratio of 2:3.

Net assets available for shares	and the state	Preference	Equity
		Rs.	Rs.
Share of net assets	hangus saudi sa	1,86,200	2,79,300
Arrear preference dividend		24,000	-
		2,10,200	2,79,300

Value of each share:

Preference share = Rs.2,10,200/20,000 = Rs.10.52 (cum-div)

Equity share = Rs.2,79,300/30,000 = Rs.9.31 (ex-div)

3.13 Fair Value of Share

This is, of course, no valuation, but a compromise formula for bringing parties to an agreement. The fair value is simply the average of the values obtained by net asset method and yield method. It often argued that the average of net asset value and yield value incorporates the merits of both the methods. For this reason, such average is called fair value. Thus, fair value per share = (Net asset value + Yield value)/2.

Illustration 10:

Mr. Angik wants to buy 1,000 shares of Prosperous Ltd. on the basis of fair value of shares. You are asked to determine the total amount to be paid by Mr. Angik from the under-noted Balance Sheet and additional information:

Liabilities	Amount	Assets	Amount
BIR 194	Rs.		Rs.
Equity Shares (Rs. 10)	1,20,000	Goodwill	15,000
Reserve Fund	1,00,000	Building	1,50,000
Profit & Loss A/c	15,000	Machinery	60,000
8% Debentures	50,000	Investments	30,000
Creditors	52,500	Stock	45,000
		Debtors	30,000
		Bank	7,500
	3,37,500	omorphism of death	3,37,500

Additional information:

Market value of the assets has been assessed as under:

Goodwill-Rs.37,500

Building-Rs.2,25,000

Machinery—Rs.45,000 Investments—Rs.22,500

(ii) Net profits after 40% taxation for the last three years were as under:

For the year ended 31.3.2002 Rs. 40,000

For the year ended 31.3.2003 Rs. 39,000

For the year ended 31.3.2004 Rs. 41,000

- (iii) Fair return in the similar business is 12%.
- (iv) Ignore depreciation on the increased value of assets.
- (v) All investments are trading investments.

Ne	t Asset	Value
1.46	1 1 7 2 2 2 7 1	A COURSE

Net	Assets available for	equity share	holders:	Rs.	Rs.
Goo	odwill			editare restra	5.,000
Bui	lding			n alkadan ar and sad	2.25.000
Ma	chinery				45,000
Inv	estments				22,500
Sto					15 000
De					
Ba	nk				7,500
					4,12,500
Less :	External Liabilities :			a intesti	
	8% Debentures	Buckting		50,000	March Second
	Creditors			52,500	1.02.500
		doomestal			3,10,000

Value per equity share = (Rs.3,10,000)/(12,000) = Rs.25.83 Approx.

Yield Method

Profit available for dividend: Rs. After tax average profit [(36,000 + 39,000 + 42,000)/(1 + 2 + 3)] 40,000 Less: Transfer to reserve (as there is sufficient reserve) Nil $\frac{Nil}{40,000}$

Company expectation = $(Rs.40,000)/(1,20,000) \times 100 = 33.33\%$ Approx. Market expectation = 12% (Given) Value per equity share = $(33.33\%)/(12\%) \times Rs.10 = Rs.27.78$ Approx.

Fair Value

Fair value per equity share = (25.83 + 27.78)/2 = Rs.26.80 Approx.

Thus, has to pay for acquiring 1,000 shares of Prosperous Ltd. = Rs.26.80 × 1,000 = Rs.26,800 Approx.

Illustration 11:

The Balance Sheet of Sunflower Ltd. as on December 31, 2005 is as below:

Liabilities	Amount	Assets	Amount
Stella Guibs graf and	Rs.	ANT LINE AND TO THE ALE AND THE	Rs.
Share Capital		Fixed Assets	The second
Equity shares of	1. Brodes	Goodwill	70,000
Rs. 100 each 7,50,000		Machinery	3,80,000
Less: Calls in arrear		Factory Shed	4,10,000
(Rs. 20 for all		Vehicles	1,05,000
final call) 30,000	7,20,000	Furniture	40,000
8% Preference shares of		Investments	1,60,000
Rs. 100 each	3,00,000	Current Assets	Easing
Reserves and Surplus	T	Stock-in-trade	3,00,000
General Reserve	2,80,000	Sundry Debtors	5,25,000
Profit & Loss A/c	2,00,000	Cash at Bank	80,000
Current Liabilities		Miscellaneous Expenditure	
10% Bank Loan	1,50,000		30,000
Sundry Creditors	4,50,000		
	21,00,000	Maril Sharts (Nicht Magel)	21,00,000

Additional information:

- (1) Fixed assets are worth 20% above book value. Depreciation on appreciated value of fixed assets not to be considered for valuation of goodwill.
- (2) Of the investments, 70% is non-trading and the balance is trading. All trade investments are to be valued at 20% above cost. A uniform dividend @10% is carned on all investments.
- (3) For the purpose of valuation of shares, goodwill is to be considered on the basis of 5 years' purchase of super profit based on average profit of last 3 years. Profits (after 40% tax) are as follows:

2003: Rs.3,00,094; 2004: Rs.3,54,148 and 2005: Rs.3,87,162

In similar business, return on capital employed is 15%

(4) In 2003, new machinery costing Rs.20,000 was purchased but wrongly charged to revenue. No effect has yet been given for rectifying the same. Depreciation charged on machinery is @ 10% per annum under reducing balance method.

(5) The rates of equity dividend for the last 2 years were 18% and 19% respectively. For the year 2005, proposed dividend is 20%. Similar companies pay dividend @ 16% and the share is quoted on the stock exchange Rs.120 each.

Find out the fair value of each fully paid and partly paid equity share.

478	80		4.4		
36		lu	21	n	20
LJ	N	ıи	L a	v	88

Valuation of Equity Shares (Net Asset Method) :	Rs.
Capital employed on 31.12.2005 [Working Note (2)]	15,02,096
Add: Goodwill [Working Note (3)]	7,95,130
Market value of non-trading investments (1,60,000 × 70% × 120%)	1,34,400
Calls in arrear	30,000
Net assets available for shares	24,61,626
Less: Preference share capital	3,00,000
Net assets available to equity shares (a)	21,61,626
Number of shares (b)	7,500
Value of each fully paid up share [(a)/(b)]	Rs.288.22
Value of each partly paid up share (Fully paid up value - unpaid call)	Rs.268.22

Valuation of Equity Shares (Yield Method):

(a) On the basis of expected dividend:		Rs.
Weighted average profit after taxes		3,55,880
Less: Transfer to General Reserve assumed (@ 20%	71,176
Preference dividend (3,00,000 × 8%)	24,000	95,176
Profit available for equity dividend		2,60,704

Company expectation= (Profit available for equity div.) x 100]/Paid up equity capital = (Rs.2,60,704 × 100)/Rs.7,50,000 = 34.76%

Market expectation = [(Dividend per share) \times 100]/(Market price per share) = (Rs.16 \times 100)/Rs.120 = 13.33%

Market value per share = $[{(Company expectation) \times (Paid up value)}/(Market expectation)]$:

Fully paid up = $(34.76\% \times Rs.100)/13.33\%$] = Rs.260.77Partly paid up = $[(34.76\% \times Rs.80)/13.33\%]$ = Rs.208.61

Fair value per share:

Fully paid up = Rs.(282.22 + 260.77)/2 = Rs.271.50

Partly paid up = Rs.(268.22 + 208.61)/2 = Rs.238.42

(b) On the basis of actual dividend:

As there is a clear upward trend in actual dividend paid, weighted average dividend is desirable in order to find out company dividend. Assuming weights are1, 2 and 3 for the years 2003, 2004 and 2005 respectively.

Company dividend = $(18\% \times 1 + 19\% \times 2 + 22\% \times 3)/(1 + 2 + 3) = 19.33\%$ Market dividend=13.33%

Market value per share = [{(Company dividend) × (Paid up value)}/(Market dividend)

Fully paid up = $[(19.33\% \times Rs.100)/13.33\%] = Rs.145.00$

Partly paid up = $[(19.33\% \times Rs.80)/13.33\%] = Rs.116.00$

Fair value of a share:

Fully paid up = Rs.(282.22 + 145.00)/2 = Rs.213.61

Partly paid up = Rs.(268.22 + 116.00) = Rs.192.11

Working Notes:

1. Average profit after taxes of the last 3 years :

Particulars	2003	2004	2005
	Rs.	Rs.	Rs.
Profit after tax @ 40%	3,00,094	3,54,148	3,87,162
Add: Purchase of mach, wrongly charged to revenue, net of tax	12,000	un to bala	_
Less: Depreciation at 10% on machinery less tax 40%	(1,200)	(1,080)	(972)
Less: Income from non-trading investments, net of tax @ 40% (1,60,000 × 70% × 10% × 60%)	(6,720)	(6,720)	(6,72)
	3,04,174	3,46,348	3,79,470

Since there is a sharp increasing trend in profit, weighted average profit is suitable. Assuming weights are 1, 2 and 3 for the year 2003, 2004 and 2005 respectively, weighted average profit after taxes will be:

 $[(Rs.3,04,174 \times 1) + (3,46,348) \times 2 + (3,79,470 \times 3)]/(1 + 2 + 3) = Rs.3,55,880$

(2) Average capital employed on 31.12.2005:	Rs.
Machinery (3,80,000 + 20,000 × 90% × 90% × 90%)	
Factory Shed	4,10,000
Vehicles	1,05,000
Furniture	40,000
	9,49,580
Add: Increase in fixed assets @ 20%	1,89,916
Current market value of fixed assets	11,39,496
Trade Investments (1,60,000 x 30% x 120%	57,600
Stock-in-trade	3,00,000
Sundry Debtors	5,25,000
Cash at Bank	80,000
	21,02,096
Less: Current Liabilities:	
10% Bank Loan 1,50,000	
Sundry Creditors 4,50,000	6,00,000
Capital employed on 31.12.2005 15,02,096	
Less: $\frac{1}{2}$ of current year's trading profit after taxes (3,79,470 × $\frac{1}{2}$)	1,89,735
Average capital employed on 31.12.2005	13,12,361
(3) Value of goodwill:	Rs.
Weighted average profit after taxes	3,55,880
Less: Normal return on average capital employed	
(13,12,361 × 15%)	1,96,854
Super profit	1,59,026
Goodwill = Super profit x 5 years' purchase = Rs.1,59,026 \times 5 = E	Rs7,95,130

3.14 Summary

Valuation of shares demands valuation of goodwill. Valuation of goodwill and shares are the most controversial issues in financial accounting. Determination of capital employed, future maintainable profit, super profit, and the number of years for which either future maintainable profit or super profit can be maintained requires

subjective judgment. Thus, result of subjective judgment of anyone may differ with the result another; even it may differ between attitudes of oneself at different circumstances. Nevertheless, valuation of goodwill and shares are made using popular methods and conventions so that the chance of variation of computed result is minimum.

3.15 Exercises

Problem 1:

Following information of Eastern Ltd. are available:

- 1. Profits earned after taxes: 2001 Rs. 80,000; 2002 Rs. 88,000 and 2003 Rs. 84,000
- 2. Normal rate of return: 10%
- 3. Capital employed: Rs. 7,50,000 including 8% debentures of Rs. 1,50,000
- 4. Present value of an annuity of rupee one for 5 years at 10% is Rs. 3.78
- Profits included non-recurring profits on an average Rs. 4,000 out of which it was deemed that even non-recurring profits had a tendency of appearing at the rate of Rs. 1,000 per year.
- 6. Tax rate is 40%.

You are asked to ascertain the value of goodwill using:

- (a) Super profit method, assuming super profit can be maintained for 5 years;
- (b) Capitalisation of (i) future maintainable profit and (ii) super profit; and
- (c) Annuity method.

Answers:	Shareholders' fund	Long term fund
Value of goodwill:	approach (Rs.)	approach (Rs.)
(a) Super profit method	1,11,000	96,000
(b) Capitalisation method, for both (i) & (ii)	2,22,000	1,92,000
(c) Annuity method	83,916	72,576

Problem 2:

The capital structure of Z Ltd. is made up as follows:

15,000 Equity Shares of Rs.100 each fully paid	Rs. 15,00,000
9,000 10% Preference Shares of Rs.100 each fully paid	Rs. 9,00,000

The preference shares are participating and they are entitled to a profit of 20% after payment of preference dividend and an equity dividend of 15%. The balance of profit of will

be available for equity shareholders. It is the practice of the company to transfer 10% of profit after tax profit to general reserve.

Average profit after tax of the company is Rs.7,50,000. Normal rates of return for this type of company are 12% for preference shares and 16% for equity shares.

On the basis of above information, find out the value of each share, preference and equity using yield method.

Answer: Value of each share: preference Rs.150.00 and equity Rs.213.75

Problem 3:

The Balance Sheet of Blue Ltd. as on March 31, 2003 was as follows:

Liabilities	Amount	Assets	Amount
	Rs.	Light of the state of the light	Rs.
Share Capital	CE DOM	Fixed Assets	10 2
1,000 6% Preference Shares	Land American	Goodwill	22,000
of Rs. 100 each fully paid	1,00,000	Land & Buildings	5,40,000
3,000 Equity Shares of		Plant & Machinery	1,00,000
Rs. 100 each fully paid	3,00,000	8% Investments	
4,000 Equity Shares of		(Nominal value Rs. 60,000)	58,000
Rs. 100 each Rs. 50 per		Stock-in-trade	1,80,000
share paid	2,00,000	Sundry Debtors	1,60,000
Reserves and Surplus		Cash at Bank	20,000
General Reserve	50,000	Miscellaneous Expenditures	
Profit & Loss A/c	90,000	Preliminary Expenses	10,000
Secured Loans	WHE .		22.7770
7% Debentures	2,00,000		
Current Liabilities			
Provision for Taxation	50,000		
Sundry Creditors	1,00,000	A HEAD BY SHIMMAN STARRESCH	
	10,90,000	a builted view	10,90,000

Additional information:

1. The revaluation of assets were made as follows:

Land & Buildings Rs.5,80,000; Plant & Machinery Rs.1,40,000 and Investments are 10% above the nominal value and current assets are to be taken at their book values.

2. Of the investments, 60% is trading and the balance is non-trading.

3. For the purpose of valuation of shares, goodwill is to be considered on the basis of 4 years' purchase of super profit based on weighted average profit after taxes of last 3 years. The weights are 1, 2 and 3 for the year 2000-01, 2001-02 and 2002-03 respectively. Profits after 40% taxes are as follows:

2000-01: Rs. 99,000; 2001-02: Rs. 1,18,500 and 2002-03: Rs. 1,34,100 In similar business, normal return on capital employed is 14%.

- 4. The rates of dividend paid for last 3 years were 16%, 18% and 20% respectively. Similar companies pay dividend @ 16% and the shares are quoted on the stock exchange at Rs.125 each.
- At the beginning of 2000-01, a machine costing Rs.16,000 was purchased but wrongly charged to revenue. No rectification has yet been made in the books of account.

Depreciation were charged on plant and machinery @10% and on land and buildings @5% under diminishing balance method.

Compute fair value of each equity share,

Answer: Closing capital employed (using equity approach) Rs.7,81,264; Average capital employed Rs. 7,16,979; Value of goodwill Rs. 81,936; Net asset value per share: fully paid Rs. 141.37, partly paid Rs. 91.37; Yield value per share: on the basis of expected dividend (using weighted average)—fully paid Rs. 141.72, partly paid Rs. 70.86; on the basis of actual dividend (using weighted average)—fully paid Rs. 145.86, partly paid Rs. 72.93; Fair value per share: fully paid Rs. 141.55 and/or Rs. 143.62, partly paid Rs. 70.86 and/or Rs. 82.15.

3.16 Questions

- Q.1 What is goodwill? Explain different methods of valuation of goodwill. Which method of valuation of goodwill is considered to be the best?
- Q.2 Can goodwill be sold alone? State the special features of goodwill. What are the circumstances where the need for valuation of goodwill arises in case of a company?
- Q.3 Why is average capital employed preferable in valuing goodwill? Why is 'Equity Approach' more acceptable over 'Long Term Fund Approach' in the light of valuation of shares of a company?

Q.4 Explain different methods of valuation of shares. State the choice of the particular method by equity shareholders who demand safety, security and asset cover. Also state the choice of the method by the holders of large block of shares for speculative motive and by the holders of small block of shares for receiving regular dividend and capital gain motive.

3.17 Suggested Readings

- 1. Chakraborty, H: Advanced Accountancy, Oxford University Press.
- Shukla, M.C; Grewal, T. S. & Gupta, S. C: Advanced Accounts, S. Chand & Co. (Pvt.) Ltd.
- 3. Maheshwari, S.N: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.

Unit 4 Cash Flow Statement

Structure

- 4.0 Objective
- 4.1 Introduction
- 4.2 Meaning of Cash Flow Statement
- 4.3 Difference between Fund Flow Statement and Cash Flow Statement
- 4.4 Benefits of Cash Flow information
- 4.5 Meaning of some important terms used in Cash Flow Statement
- 4.6 Presentation of a Cash Flow Statement
- 4.7 Operating Activities
- 4.8 Investing Activities
- 4.9 Financing Activities
- 4.10 Summary
- 4.11 Exercises
- 4.12 Questions
- 4.13 Suggested Readings

4.0 Objective

By the time you have read this unit you will be able to :

- highlight the benefits of preparing cash flow statement;
- prepare cash flow statement as per AS-3; and
- provide information about cash flows of an undertaking.

4.1 Introduction

To run an organisation smoothly the importance of cash is highly recognised by all concerned. Cash is required to meet obligations maturing on account of purchases of raw materials, payment of wages and salaries, meeting other operating expenses, payment of interest, taxes, dividends, repayment of borrowed funds, etc. But earning

of profit is unlikely to generate equal amount of cash to enable the firm to meet these obligations. A firm may face serious cash crisis in spite of huge amount of profit reported by its profit and loss account adopting accrual accounting concept which is incapable of highlighting the cash earning capacity of the firm whereas a firm may be flooded with cash in spite of huge reported loss. Different interested parties such as investors, prospective investors, creditors, bankers, etc. are highly interested in cash earning capacity of the firm.

4.2 Meaning of Cash Flow Statement

Cash flow statement discloses the impact of all transactions over a period of time on the cash position of the firm. It summarises the causes leading to change of cash and cash equivalents between two balance sheet dates. It provides information regarding the amount of cash generated from different sources, their uses and finally the net impact on the cash and cash equivalents during the period. Timely payment of obligations requires the procurement of cash from different sources through effective cash management. Moreover, by timely payment of obligations, a firm can gain confidence of suppliers of goods and services on credit over the firm's liquidity and can retain its reputation and goodwill as well. Thus, both from firm and creditors' point of view, cash flow statement can be considered as one of the measures of liquidity. In this context, cash flow statement can be defined as a statement of measuring liquidity in which cash collections (i.e. cash inflows) and cash payments (i.e. cash outflows) between two balance sheet dates are shown in such a systematic manner so that it can explain how is opening cash and cash equivalents converted into closing cash and cash equivalents.

4.3 Difference between Funds Flow Statement and Cash Flow Statement

Both funds flow and cash flow statements are prepared with a view to showing the changes in the financial position of the business usually between two balance sheet dates. They have become important tools of management in financial planning and control. For preparation of both funds flow and cash flow statements, relevant figures in the balance sheets and those in the profit and loss account for a period and certain other information are required. As a matter of fact, funds flow and cash flow statements are complementary to each other. Thus, they should be prepared

simultaneously in order to make an in-depth analysis of the financial position of a business. Nevertheless, they differ in respect of the following :

- Funds flow statement deals with how working capital position or all financial resources position using wider concept of fund, changes over a period of time while cash flow statement deals with the change in cash position of a firm over the period of time.
- Funds flow statement is based on 'accrual basis' of accounting whereas cash
 flow statement is based on 'cash basis' of accounting. That is why, while
 preparing the cash flow statement, operating profit or loss as per accrual
 basis of accounting requires some adjustments in order to arrive at cash
 operating profit or loss.
- Funds flow statement is generally accompanied by a supplementary statement showing changes in working capital over a period of time under consideration. No such statement accompanies the cash flow statement.
- Funds flow statement is helpful for immediate and long-range planning while cash flow statement is suitable for short-term and long-range planning.

4.4 Benefits of Cash Flow Information

Benefits of cash flow information are as follows:

- 1. A cash flow statement, when used in conjunction with the other financial statements provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.
- Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices.

4.5 Meaning of Some Important Terms Used in Cash Flow Statement

The following terms are used in the cash flow statement with the meanings specified:

Cash comprises cash on hand and demand deposits with banks.

Cash equivalents are short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows are inflows and outflows of cash and cash equivalents.

Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.

Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

4.6 Presentation of a Cash Flow Statement

Presentation of cash flow statement is made as under:

- The cash flow statement should report cash flows during the period classified by operating, investing and financing activities.
- 2. An enterprise presents its cash flows from operating, investing and financing activities in a manner, which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the enterprise and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities.
 - 3. A single transaction may include cash flows that are classified differently. For example, when the instalment paid in respect of a fixed asset acquired on deferred payment basis includes both interest and loan, the interest element is classified under financing activities and the loan element is classified under investing activities.

4.7 Operating Activities

Operating activities include the following:

- 1. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the enterprise, pay dividends, repay loans and make new investments without resourse to external sources of financing. Information about the specific components of historical operating cash flows is useful, in conjunction with other information, in forecasting future operating cash flows.
- 2. Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the enterprise. Therefore, they generally result from the transactions and other events that enter into the determination of net profit or loss. Examples of cash flows from operating activities are:
 - (a) cash receipts from the sale of goods and the rendering services;
 - (b) cash receipts from royalties, fees, commissions and other revenue;
 - (c) cash payments to suppliers for goods and services;
 - (d) cash payments to and on behalf of employees;
 - (e) cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities and other policy benefits;
 - (f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and
 - (g) cash receipts and payments relating to future contracts, forward contracts, option contracts and swap contracts when the contracts are held for dealing or trading purposes.
- Some transactions, such as the sale of an item of plant, may give rise to a
 gain or loss which is included in the determination of net profit or loss.
 However, the cash flows relating to such transactions are cash flows from
 investing activities.
- 4. An enterprise may hold securities and loans for dealing or trading purposes, in which case they are similar to inventory acquired specifically for resale. Therefore, cash flows arising from the purchase and sale of dealing or trading securities are classified as operating activities. Similarly, advances and loans made by financial enterprises are usually as operating activities since they relate to the main revenue-producing activity of that enterprise.

4.8 Investing Activities

These include the following:

- The separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:
 - (a) cash payments to acquire fixed assets (including intangibles). These
 payments include those relating to capitalised research and development
 costs and self-constructed fixed assets;
 - (b) cash receipts from disposal of fixed assets (including intangibles);
 - (c) cash payments to acquire shares, warrants or debt instruments of other enterprise and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
 - (d) cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
 - (e) cash advances and loans made to third parties (other than advances and loans made by a financial enterprise);
 - (f) cash receipts from the repayment of advances and loans made to third parties (other than advances and loans of a financial enterprise);
 - (g) cash payments for future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
 - (h) cash receipts from future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.
 - When a contract is accounted for as a hedge of an identifiable position, the cash flows of the contract are classified in the same manner as the cash flows of the position being hedged.

4.9 Financing Activities

These activities include the following:

- The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of funds (both capital and borrowings) to the enterprise. Examples of cash flows arising from financing activities are:
 - (a) cash proceeds from issuing shares or other similar instruments;
 - (b) cash proceeds from issuing debentures, loans, notes, bonds, and other short or long-term borrowings; and
 - (c) cash repayments of amounts borrowed.

Illustration 1: Preparation of Cash Flow Statement under Direct Method

From the following Balance Sheets and Profit & Loss Account of Venus Ltd., prepare a Cash Flow Statement for the year ended March 31, 2005:

Liabilities	31.3.04	31.3.05	Assets	31.3.04	31.3.05
Share Capital 10% Debentures Reserve & Surplus Accounts Payable Outstanding Expenses	Rs. 1,25,000 20,000 35,000 4,000 1,84,000	Rs. 1,50,000 50,000 28,000 40,000 3,000 2,71,000	Fixed Assets Inventories Accounts Receivable Prepaid Expenses Cash at bank	Rs. 1,00,000 25,000 40,000 6,000 13,000	Rs. 1,60,000 45,000 55,000 5,000 6,000

Profit & Loss Account for the year ended March 31, 2005

	Rs.	Rs.
Sales		2,50,000
Less: Cost of goods sold		1,85,000
Gross Profit		65,000
Less: Other Expenses:		05,000
Employees remuneration	10,000	100
General expenses	25,000	
Depreciation	10,000	45,000
Net Profit	231000	20,000
Less: Dividend		100000000000000000000000000000000000000
		12,000
Add: Reserves & Surplus (1.4.2004)		8,000
Deserves & Surplus (1.4,2004)	The later and	20,000
Reserves & Surplus (31.3.2005)		28,000

Solution

Cash Flow Statement for the year ended March 31, 2005 (Direct Method)

Cash flows from operating activities: Collections from customers		Rs. 2,35,000	Rs.
Less: Cash paid to suppliers Payment for expenses	2,00,000 35,000	2,35,000	Nil
Net cash from operating activities 2. Cash flows from investing activities: Purchase of fixed assets Net cash used in investing activities		70,000	(70,000)
Cash from financing activities: Proceeds from issue of shares Proceeds from issue of 10% debentures		25,000 <u>50,000</u> 75,000	edicinalism Menda
Less: Payment of dividend Net cash from financing activities Net decrease in cash over the year Add: Cash and cash equivalents on 1.4.2004 Cash and cash equivalents on 31.3.2005		12,000	63,000 (7,000) 13,000 6,000

Working Notes:

1. Payment to Suppliers:	Rs.	3. Payment for Expenses:	Rs.
Cost of goods sold	1,85,000	Employees remuneration	10,000
Add : Closing inventories	45,000	General expenses	25,000
	2,30,000		35,000
Less :Opening inventories	25,000	Add : Op. outstanding exp.	4,000
Purchases	2,05,000	Cl. prepaid exp.	5,000
Add : Op. Accounts payable	35,000		44,000
	2,40,000	Less :Op. prepaid exp. 6,000	
Less :Op. Accounts payable	40,000	Cl. outstanding exp. 3,000	9,000
	2,00,000		35,000
2. Collection from Customers:	Rs.	4. Purchase of Fixed Assets:	Rs.
Total sales	2,50,000	Closing balance	1,60,000
Add : Op. Accounts receivable	40,000	Add : Depreciation	10,000
Aud. Op. 1200	2,90,000		1,70,000
Less :Cl. Accounts receivable	55,000	Less :Opening balance	1,00,000
7	2,35,000		70,000

Illustration 2: Preparation of Cash Flow Statement under Indirect Method from financial statements of Illustration 1.

Solution

Cash Flow Statement for the year ended March 31, 2005 (Indirect Method)

Cash flows from operating activities: Operating profit (Working Note 1)	and the	Rs. 30,000	Rs.
Add: Decrease in Current Assets and increase in Current Liabilities except Cash & Bank:			
Decrease in Prepaid Expenses	1,000	1 - 1970 - 19	
Increase in Accounts Payable	_5,000	<u>_6,000</u> 36,000	
Less : Increase in Inventories	20,000		
Increase in Accounts Receivable	15,000		
Decrease in Outstanding Expenses	1,000	36,000	
Net from operating activities			Nil
2. Cash flows from investing activities:			
Purchase of Fixed Assets		70,000	
Net cash used in investing activities		To Social	(70,000)
3. Cash flows from financing activities:			*
Proceeds from issue of Shares		25,000	
Proceeds from issue of 10% Debentures		50,000	
		75,000	
Less : Payment of dividend		12,000	
Net cash from financing activities			63,000
Net decrease in cash over the year			(7,000)
Add: Cash and cash equivalents on 1.4.2004		THE PARTY	13,000
Cash and cash equivalents on 31.3,2005			6,000

Working Note:

(1)	Profit &	Loss A/c	
To Depreciation To Dividend To Reserves & Surplus	Rs. 10,000 12,000 8,000	By Operating profit (Balancing figure)	Rs. 30,000
	30,000	The standard of the standard o	30,000

Illustration 3: Preparation of cash flow statement when there is a purchase of running business.

From the following Balance Sheets and other information of Hind Ltd., prepare a cash flow statement for the year ending on March 31, 2005:

Liabilities	1.4.04	31.3.05	Assets	1.4.04	31.3.05
	Rs.	Rs.	STOT MORE ASSESSMENT	Rs.	Rs.
Share Capital (Rs.10)	5,00,000	6,00,000	Goodwill	20,000	30,000
Profit & Loss A/c	1,32,500	60,000	Land & Duilding		30,000
8% Debenture	1,50,000	2,00,000	Land & Building and Machinery	6,20,000	6,90,000
Debenture Int. Due	3,000	4,000	Advance	40,000	60,000
Proposed Dividend	50,000	60,000	Inventories	1,70,000	1,81,000
Unclaimed Dividend	6,000	4,000	Debetors	1,50,000	1,80,000
Depreciation Fund	1,25,000	1,75,800	Cash at Bank	10,000	15,000
Inventory Provision	8,000	9,500	Debenture Discount	4,000	5,000
Provision for Tax	19,500	17,600		1,000	3,000
Creditors	20,000	30,100		290.00	
	1014000	1161000		1014000	1161000

Other relevant information:

- (a) Debentures were issued at 5% discount on April 1, 2004.
- (b) Machine costing Rs.20,500 (accumulated depreciation Rs.16,000) has been discarded and written off. At the end of March 2005, however, the scrap was sold for Rs.500.
- (c) A running business was purchased in the year by issue of 10,000 shares at par. The business had Machinery Rs.30,000, Stock Rs.40,000, Debtors Rs.40,000 and Creditors Rs.35,000.
- (d) A Machine was purchased for Rs.40,000 in cash.

Solution:

Cash Flow Statement for the year ending on March 31, 2005 (Indirect Method)

	Rs.	Rs.
1. Cash flows from operating activities:	oras lenda	most i
Operating profit (Working Note 10)	93,000	
Add: Debenture interest	16,000	
Operating profit before interest	1,09,900	

		Rs.	Rs.
Add: Decrease in Current Assets and increase in Current Liabilities			
except Cash & Bank:			
Decrease in Inventories		erale Vitini	
[1,70,000 - (1,81,000 - 40,000)]	29,000	nti sendati	
Decrease in Debtors			
[1,50,000 - (1,80,000 - 40,000)]	10,000	39,000	
		1,48,900	
Less : Increase in Current Assets and			
decrease in Current Liabilities	Sale		
except Cash & Bank:			
Increase in Advance (60,000 - 40,000)	20,000	in Indibut	Short
Decrease in Creditors			
[20,000 - (30,100 - 35,000)]	24,900	44,900	To the state of
		1,04,000	
Less: Payment of income tax		19,500	
Net cash from operating activities			84,500
2. Cash flows from investing activities :			100
Sale of scrap		500	-
Less : Addition to Land & Building	20,500		
Purchase of Machinery for cash	40,000	(60,500)	
Net cash used in investing activities			(60,000)
3. Cash flows from financing activities:			
Proceeds from issue of 8% Debenture (Net of	discount)	47,500	
Less : Payment of Debenture interest	15,000		
Payment of Dividend	52,000	67,000	
Net cash used in financing activities			(19,500)
Net increase in cash over the year			5,000
Add: Cash and cash equivalents on April 1, 2	2004		10,000
Cash and cash equivalents on March 31, 2005			15,000

Working Notes:

(1)

Land & Building and Machinery A/c

	Rs.		Rs.
To Balance b/d	6,20,000	By Machinery Discarded	20,500
To Sundries (Machinery purchased by shares)	30,000	By Balance c/d	6,90,000
To Bank (Machine purchased for cash)	40,000		
To Bank (Addition to Land & Building-Balancing figure)	20,000	500,00 = \$40,00;1) = 566 (2.1)	
	7,10,500		7,10,500

(2)

Machinery Discarded A/c

	Rs.	OUT OUT OF BUILDING	Rs.
To Land, Building & Machinery	20,500	By Depreciation Fund (Accumulated depreciation on machine discarded)	16,000
		By Bank (Sale of scrap) By Profit & Loss	500
		(Loss on scrap)	4,000
	20,500	mental bearings and a	20,500

(3)

Depreciation Fund A/c

	Rs.		Rs.
To Machinery Discarded To Balance c/d	16,000 1,75,800	By Balance b/d By Profit & Loss (Depreciation charged— Balancing figure)	1,25,000 66,800
	1,91,800		1,91,800

(4)

Goodwill A/c

a delica	Rs.	TO SELECT TO BEST OF THE PROPERTY OF	Rs.
To Balance b/d To Sundries	20,000 25,000	By Profit & Loss (Written off—Balancing figure) By Balance c/d	15,000
	45,000		45,000

(5)

Share Capital A/c

	Rs.	EW - F - S - S - S - S - S - S - S - S - S	Rs.
To Balance c/d	6,00,000	By Balance b/d	5,00,000
SELECTION OF THE SELECT	authorized to a	By Sundries (Bus. purchase)	1,00,000
S Refino	60,000	entre de la laction de la company	60,000

(6)

Debenture Discount A/c

	Rs.	Editor I Tolking	Rs.
To Balance b/d	4,000	By Profit & Loss (Written off)	1,500
To 8% Debenture	2,500	By Balance c/d	5,000
	6,500		6,500

(7)

Debenture Interest A/c

	Rs.	NGEN CHANGE PARENCE	Rs.
To Bank (Balancing figure) To Balance c/d	15,000 4,000	By Balance b/d By Profit & Loss (current year's interest)	3,000 16,000
	19,000		19,000

(8)

Provision for Tax A/c

	Rs,	w lamin = festestificati	Rs.
To Bank (payment) To Balance c/d	19,500 17,600	By Balance b/d By Profit & Loos (current year's provision)	19,500 17,600
IL LONG WAS THE RU	37,100		37,100

(9)

Proposed Dividend A/c

H-	Rs.		Rs.
To Bank [50,000 + (6,000 - 4,000)]	52,000	By Balance b/d (50,000 + 6,000)	56,000
To Balance c/d (60,000 + 4,000)	64,000	By Profit & Loss (current year's provision	60,000
	1,16,000		1,16,000

	Rs.		Rs.
To Depreciation	66,800	By Balance b/d	1,32,500
To Inventory provision	1,500	By Operating profit	1,93,900
To Machinery scrapped (loss)	4,000	(Balancing figure)	
To Debenture discount (w/o)	1,500		
To Goodwill (w/o)	15,000	Selberulari	
To Provision for tax	17,600		
To Proposed dividend	60,000		Total Trans
To Balance c/d	60,000		
	2,26,400		2,26,400

11. Payment for Goodwill in purchasing business: Rs. Paid up value of 10,000 shares issued at Rs.10 each 1,00,000 Less: Net value of assets acquired: 30,000 Machinery 40,000 Stock 40,000 Debtors 1,10,000 75,000 35,000 Less: Creditors 25,000

12. Unclaimed dividend is treated with proposed dividend in order to find out the total payment of dividend.

Illustration 4:

The following are the summarised Balance Sheets of X Ltd. as on March 31, 2004 and March 31, 2005:

Liabilities	31.3.04	31.3.05	Assets	31.3.04	31.3.05
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital	3,00,000	4,00,000	Goodwill	1,00,000	80,000
(Rs.10 each)	Tales (No.		Land & Building	2,00,000	1,70,000
10%Pref. Share Cap.	1,50,000	1,00,000	Plant	80,000	2,00,000
Capital Reserve	_	20,000	Investment	20,000	30,000
General Reserve	40,000	50,000	Stock	77,000	1,09,000

Profit & Loss A/c	30,000	48,000	Debtors	1,40,000	1,70,000
Creditors	25,000	- 47,000	Bill Receivable	20,000	30,000
Bills Payable	20,000	16,000	Bank	10,000	8,000
Outstanding Exp.	30,000	36,000	Cash	15,000	10,000
Prov. for Taxation	40,000	50,000	Preliminary Expenses	15,000	10,000
Proposed Dividend	42,000	50,000			
	6,77,000	8,17,000		6,77,000	8,17,000

Additional Information:

- (a) A piece of land has been sold out during 2004-05 and the profit on sale has been credited to Capital Reserve.
- (b) A Plant has been sold for Rs.10,000. The W.D.V. of the Plant was Rs.12,000. Depreciation of Rs.10,000 is charged on Plant during 2004-05.
- (c) A dividend of Rs.3,000 was received on Investment out of which Rs.1,000 was pre-acquisition profit which has been credited to Investment A/c.
- (d) An interim dividend of Rs.20,000 has been paid on October 31, 2004.
- (e) Bonus Shares at 1 for every 3 Equity Shares held were issued out of Capital Reserve.

You are required to prepare Cash Flow Statement for the year ended 31.3.2005.

Solution:

Cash Flow Statement for the year ending on March 31, 2005 (Indirect Method)

		Rs.	Rs.
1. Cash flows from operating activities:			La MA
Operating profit (Working Note 14)		1,83,000	
Add: Decrease in Current Assets and increa	ise in		
Current Liabilities except Cash & Bar	nk:	nematical state	
Increase in Creditors	22,000		
Increase in Outstanding Expenses	6,000	28,000	
		2,11,000	
Less : Decrease in Bills Payable	4,000		
Increase in Stock	32,000		
Increase in Debtors	30,000	The State of	
Increase in Bills Receivable	_10,000	76,000	
		1,35,000	
Less: Income tax paid		40,000	
Net cash from operating activities		0	95,000

2. Cash flows from investing activities:	Chille Marine	1.50.000	1 × 11304
Sale of Land & Building	ABUSE TARREST	1,50,000	Etc. I Book
Sale of Plant	1,6000	10,000	A MARIN
Dividend received on Investment	annat Inimie	3,000	m lette bend
		1,63,000	
Less : Purchase of Plant	1,42,000		
Additional Investment	_11,000	1,53,000	1.150
Net cash from investing activities	THE TOWN HERE		10,000
3. Cash flows from financing activities:		10000	L. Olivano
Redemption of 10% Preference Shares		50,000	
Dividend paid		_62,000	A September
Net cash used in financing activities		12	(1,12,000
Net decrease in cash over the year			(7,000
Cash and cash equivalents on 1.4.200-		THE RESIDENCE	25,000
Cash and cash equivalents on 31.3.05	(10,000 + 8,000)		18,00

Working Notes:

(1) Capital Reserve A/c

	Rs.		Rs.
To Bonus to Shareholders (3,00,000 × ¬)	1,00,000	By Land & Building (Profit on sale—Balancing figure)	1,20,000
To Balance c/d	20,000		
	1,20,000	Parallel Parallel Strampart	1,20,000

(2) Land & Building A/c

	Rs.		Rs.
To Balance b/d To Capital Reserve	2,00,000 1,20,000	By Bank (Sale proceeds— Balancing figure) By Balance c/d	1,50,000
	3,20,000	By Dalance Ou	3,20,000

(3) Plant A/c

	Rs.		Rs.
To Balance b/d	80,000	By Depreciation	10,000
To Bank (Purchase of Plant	1,42,000	By Bank (Sale)	10,000
-Balancing figure		By P & L (Loss on sale)	2,000
		By Balance c/d	2,00,000
	2,22,000		2,22,000

(4)	Dividend	of	Investment	A /
(4)	Dividend	OI	mvestmem	LN

	Rs.		Rs.
To Investment (Pre- acquisition dividend) To Profit & Loss (Post- acquisition dividend)	1,000 2,000	By Bank	3,000
	3,000		3,000
(5)	Investmen	nt A/c	1100 100
	Rs.		Rs.
To Balance b/d To Bank (Further Investment —Balancing figure)	20,000 11,000	By Dividend on Investment By Balance c/d	1,000 30,000
	31,000		31,000
(6)	Goodwil	l A/c	
	Rs.		Rs.
To Balance b/d	1,00,000	By Profit & Loss (Written off—Balancing figure) By Balance c/d	20,000 80,000
*	1,00,000		1,00,000
(7) Pi	eliminary Ex	cpenses A/c	Trankii
	Rs.		Rs.
To Balance b/d	15,000	By Profit & Loss (Written off—Balancing figure) By Balance c/d	5,000
	15,000		15,000
(8) E	quity Share	Capital A/c	
	Rs.		Rs.
To Balance c/d	4,00,000	By Balance b/d By Bonus to Shareholders	3,00,000 1,00,000
THE TAX PERSONS AND THE	4,00,000		4,00,000
(9) 10% 1	Preference S	hare Capital A/c	NAME OF
	Rs.	And zalony it, a posterior	Rs.
To 10% Pref. Shareholders To Balance c/d	50,000 1,00,000	By Balance b/d	1,50,000
	1,50,000		1,50,000

10% Preference Shareholders A/c

	Rs.		Rs.
To Bank	50,000	By 10% Pref. Share Capital	50,000
	50,000	Lare Sout, nilli	50,000

(11)

General Reserve A/c

000	Rs.		Rs.
To Balance c/d	40,000	By Balance b/d By Profit & Loss (Transfer— Balancing	30,000 10,000
Link is the family of the	40,000		40,000

(12)

Provision for Taxation A/c

	Rs.		Rs.
To Bank	40,000	By Balance b/d	40,000
To Balance c/d	50,000	By Profit & Loss (Transfer— Balancing figure)	50,000
	90,000		90,000

(13)

Proposed Dividend A/c.

	Rs.		Rs.
To Bank (42,000* + 20,000)	62,000	By Balance b/d	42,000
To Balance c/d	50,000	By Profit & Loss (Transfer— Balancing figure)	70,000
	1,12,000		1,12,000

^{*} Includes Preference Dividend.

(14)

Profit & Loss A/c

	Rs.		Rs.
To Depreciation	10,000	By Balance b/d	30,000
To Plant (Loss on sale)	2,000	By Dividend on Investment	2,000
To Goodwill (Written off)	20,000	By Operating profit before	1,83,000
To Preliminary Exp. (W/o)	5,000	tax (Balancing figure)	25. 5
To Provision or Taxation	50,000		7.44
To Proposed Dividend	70,000		TREE
To General Reserve (Transfer)	10,000	COLUMN TO THE PROPERTY OF	SHELLING
To Balance c/d	48,000		
	2,15,400		2,15,400

Illustration 5: Cash Flow Statement with comment on the financial position.

The Balance Sheets of Typhoon Ltd. as on December 31, 2004 and December 31, 2005 are as follows:

Th. 1	NUMBER OF STREET	C18	
152	lance	Sheets	

(Rs. in lakh)

Liabilities	2004	2005	Assets	2004	2005
	Rs.	Rs.		Rs.	Rs.
Share Capital	300.00	300.00	Freehold Property at cost	225.00	240.00
Reserves	225.00	240.00	Plant & Machinery		
6% Debentures	Trail E	1779	(at cost less depreciation)	135.00	165.00
(unsecured)	75.00	75.00	Investments in shares		
Mortgage on Freehold			of companies under the		
Property at 8%	27.00	14.25	same management		
Creditors	45.00	45.00	(unquoted)	150.00	150.00
Proposed Div. (subject			Investments in shares		
to deduction of tax	22.50	23.25	of other companies		
Provision for Taxation	21.00	37.50	(quoted) [Market	112.50	112.50
Secured Overdraft (by a			value : 2002-120 lakh		
floating charge on			2003—150 lakh]		
assets)	15.00	82.50	Stock	52.50	75.00
			Debtors	45.00	75.00
Transfer in the			Bank	10.50	
1930 1 1 1 1 = -4	730.50	817.50	THE PROPERTY OF THE SAME WE	730.50	817.50

The following additional information for the year 2005 is relevant:

(1) Credit Sales	Rs. 675.00 lakh
(2) Credit Purchases	Rs. 520.00 lakh
(3) Overheads	Rs. 83.75 lakh
(4) Depreciation on Plant & Machinery	Rs. 17.50 lakh
(E) D' 14 - 1 C - 2004	

(5) Dividend for 2004 was paid in full

(6) Amount paid towards taxation for the year 2004 Rs. 21.50 lakh

In view of credit squeeze, the company has been asked by the Bank to reduce the overdraft substantially within 6 months, if possible 50%.

You are required to prepare a Cash Flow Statement. Briefly comment on the financial position of the company and suggest remedial measures to overcome the financial crisis, if any.

Solution:

Cash Flow Statement for the year ending on December 31, 2005

(Rs. in lakh)

× manual region for		Rs.	Rs.
1. Cash flows from operating activities:	Total Total		station t
Operating profit (Working Note 7)		93.75	
Add : Interest paid (75 × 6% + 27 × 8%)		6.66	
Operating profit before interest		100.41	
Less: Increase in Stock (75.00 - 52.50)	22,50		
Increase in Debtors (75.00 - 45.00)	30.00	52.50	
		47.91	
Less : Income tax paid		21.50	
Net cash from operating activities		THE TEST	26.41
2. Cash flows from investing activities:		* 1	
Purchase of Freehold Property		15.00	
Purchase of Plant & Machinery		47.50	
Net cash used in investing activities			(62.50)
3. Cash flows from financing activities :		Separation !	12 122 123
Repayment of Mortgage Loan		12.75	
Payment of interest		6.66	
Payment of dividend		22.50	
Net cash used in financing activities			(41.91)
Net decrease in cash over the year			(78.00)
Add: Cash and cash equivalents on			
1.1.2005 (10.50 - 15.00)		Alex schools	(4.50)
Cash and cash equivalents on 31.12.2005		antsk m	(82.50)

Comment on the financial position of the company in the context of credit squeeze.

Once again a brief summary of cash flow statement with its percentage distribution is prepared to show why overdraft of the company has increased by Rs.78.00 lakh during current year as under:

Rs. 62.50 lakh	80.13%
Rs. 12.75 lakh	16.34%
Rs. 2.75 lakh	3.53%
Rs. 78.00 lakh	100.00%
	Rs. 12.75 lakh Rs. 2.75 lakh

In view of making comment on the financial position of the company, suitable ratios are calculated as below:

- (1) Interest coverage ratio = (OCF before interest)/(Interest payment) = (100.41)/6.66 = 15.08 times
- (2) Dividend ratio to operating cash flow = (Dividend payment)/(OCF) \times 100 = $(22.50)/(26.41) \times 100 = 85.20\%$
- (3) Cash earning flow ratio = $(OCF)/(Operating profit before interest) \times 100$ = $(26.41)/(100.41) \times 100 = 26.30\%$
- (4) Debt equity ratio = (Long term debt)/(Long-term fund)= (89.25)/(629.25) = 0.14:1
- (5) Cash return to net-worth ratio = (OCF Interest)/(Net-worth)= (26.41 - 6.66)/(540) = 3.66%.

Summary of the cash flow statement discloses that overdraft has increased during current year by 80.13%, 16.34% and 3.35% due to capital expenditure, repayment of loan and payment of interest & dividend in excess of operating cash inflows respectively. Only payment of dividend absorbs 85.20% of cash inflows from operating activities. Cash earning flow ratio is 26.30%, which is pathetically low while cash return to net-worth ratio, is 3.66%, which demands serious attention for financial manager in particular, and the management in general. Again, the debt equity ratio is 0.14: 1. In the favourable business economic condition, it is taken as 2: 1. So there is enough scope of using debt capital in the capital structure. But the interest coverage ratio is significantly high, which is 15.08 times. It could be made low by further long-term borrowings.

In the above situation, Typhoon Ltd. is incapable of repaying its overdraft by 50% and must not go ahead with an expansion programme. With a view to increasing the liquidity and to repaying the overdraft by 50% as well as to make capital expenditure, the company could raise its required fund through long-term borrowings in the form of issuing debentures so that the company can get advantage of financial leverage as the debt equity ratio is low and interest coverage ratio is high. As an alternative, the company could dispose of required number of unquoted shares of companies under the same management. Nevertheless, working capital management in general and cash management in particular require continuous effort to maintain required liquidity and to attain adequate profitability.

Vorking Notes :			in lakh,
(1) F	reehold Pro	perty A/c	ON NOVE
The state of the s	Rs.	6 (10) = 61/1 (9m) // 126 -	Rs.
To Bank (Purchase— Balancing figure)	15.00	By Balance c/d	240.00
To Balance c/d	225.00	description of other in the	
	240.00		240.00
(2) Pl	ant & Macl	hinery A/c	
	Rs.		Rs.
To Bank b/d	135.00	By Depreciation	17.50
To Bank (Purchase— Balancing figure)	47.50	By Balance c/d	165.00
	182.50	Total Into Nasa di India di	182.50
(3) Pro	vision for T	Taxation A/c	
Chally a service in the later than	Rs.	TO BE THE PROPERTY OF THE PARTY OF	Rs.
To Bank (Payment	21.50	By Balance b/d	21.00
To Balance c/d	37.50	By Profit & Loss (Provision for the year)	38,00
	59.00		59.00
(4) P	roposed Div	vidend A/c	sir-out
	Rs:	CHANGE UN SHU LINE THE PARTY OF	Rs.
To Bank (Payment)	22.50	By Balance b/d	22.50
To Balance c/d	23.25	By Profit & Loss (Provision for the year)	23.25
	45.75		45.75
(5)	Reserve	e A/c	San Sol
	Rs.		Rs.
To Balance c/d	240.00	By Balance b/d	225.00
	6	By Profit & Loss A/c (Transfer)	15.00
	240.00		240.00
(6) Mortga	ge on Freel	nold Property A/c	2 May 18 1
	Rs.		Rs.
To Bank (Repayment) To Balance c/d	12.75 14.25	By Balance b/d	27.00

27.00

27.00

701 mars uncarnots scott en-	Rs.	Manager of the Component	Rs.
To Depreciation	17.50	By Operating profit	93,75
To Provision for Taxation	38.00	(Balancing figure)	
To Proposed Dividend	23.25		
To Reserve	15.00		a mirror
	93.75		93.75

Illustration 6:

The summarised Balance Sheets of Strong Ltd. as on March 31, 2004 and as on March 31, 2005 are as below:

Liabilities	31.3.04	31.3.05	Assets	31.3.04	31.3.05
	Rs.	Rs.	Office And constituents	Rs.	Rs.
Equity Share Capital	3,00,000	3,50,000	Freehold Property:		
Security Premium	40,000	50,000	At cost	1,62,000	
Capital Reserve		1,09,000	As revalued	_	2,56,000
Provision for			Plant & Machinery		
Depreciation	88,500	1,02,700	at cost	2,58,000	3,05,000
Reserve for Replace-			Stock	99,600	1,62,000
ment of Mach.	40,000	45,000	Debtors	78,000	86,000
Profit & Loss A/c	40,000	35,000	Cash	12,400	10,000
10% Debentures	40,000	60,000		Si Common	
Creditors	61,500	67,300	在外层则E(12)。在台湾和	anieni.Vie	TEVEN I
	6,10,000	8,19,000	I I I THAT II SOME	6,10,000	8,19,000

Additional information:

- (1) Debentures were issued at 2% discount. The discount has been written off to Profit & Loss A/c.
- (2) Certain items of Plant & Machinery were sold for Rs. 6,800. These items had been written down to Rs. 5,000 at a rate of 10% on cost over the past eight years to March 31, 2004. The profit on sale was transferred to the Profit & Loss A/c and included in the profit for ended March 31, 2005.
- (3) Capital Reserve includes the amounts arising on revaluation of the freehold properties plus the profit made on the sale of property which originally cost Rs. 8,000.

(a) From the above information provided, you are required to prepare a Cash Flow Statement, clearly showing operating cash flow, financing cash flow and investing cash flow and (b) Also on the basis of cash flow statement prepared by you, comment on the financial position of the company.

Solution:

Cash Flow Statement for the year ended March 31, 2005

	Rs.	Rs.
1. Cash flows from operating activities:		in was a tree
Operating profit (Working Note 6)	32,800	uz g Ti d
Add : Debenture interest	6,000	
Operating profit before interest	38,800	
Add : Increase in Creditors (67,300 - 61,500)	5,800	
	44,600	
Less: Increase in Stock (1,62,000 - 99,600) 62,400	and the	Seculiar S
Increase in Debtors (86,000 - 78,000) <u>8,000</u>	70,000	- July B
Net cash used in operating activities		(25,800)
2. Cash flows from investing activities:		
Sale of Freehold Property	15,000	132-3
Sale of Plant & Machinery	6,800	
	21,800	
Less : Purchase of Plant & Machinery	72,000	
Net cash used in investing activities		(50,200)
3. Cash flows from financing activities:		
Issue of Shares at a premium	60,000	A STATE OF
[(3,50,000 + 50,000) - (3,00,000 + 40,000)]		2-
Issue of 10% Debentures (Net of discount)	19,600	
	79,600	
Less : Interest paid	6,000	PART TO SERVICE
Net cash from financing activities	1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1 1	73,600
Decrease in cash over the year	THE AND ADDRESS OF THE PARTY OF	(2,400)
Add: Cash and cash equivalents at	19.08	1916
the beginning of the year	Mit all mag	12,400
Cash and cash equivalents at the end of the year	344.8	10,000

Comment on the financial position of the company

Since both the operating cash flows and investing cash flows provide negative results, suitable ratios cannot be used in order to make comment on the financial position of the company. As an alternative to the non-availability useful ratios, cash flow statement may be reproduced showing cash sources and cash uses with its percentage distribution in the form of a common size statement with a view to making comment on the financial position of the company. The cash flow statement is reproduced as under:

Cash Flow Statement for the year ended March 31, 2005 (Reproduced)

Cash sources	Amount	%	Cash uses	Amount	%
10000 HARMAN	Rs.	AL AS	AND SECTION OF THE SE	Rs.	11 61
Net cash inflows from financing activities	73,600	96.84	Net cash outflows for operating activities :	Service Solid	an UT
Decrease in cash		56/78/7/1/	Operating profit	38,800	51.05
over the year	2,400	3.16	(+) Increase in creditors	5,800	7.63
	2001.000000		(-) Increase in stock	(62,400)	(82.10)
	n SVC ni	Balous	(-) Increase in debtors	(8,000)	(10.53)
				25,800	35.95
	out a mili	II whi	Net cash outflows for		
	Education of the	1 44	investing activities	50,200	66.05
	76,000	100.00		76,000	100.00

It is evident from the reproduced cash flow statement that net cash inflow from financing activities (96.84%) is the main source of cash while the decrease in cash provides the residue. On the other hand, huge blockage of cash in stock which alone accounts for 82.10% of total cash sources and also capital expenditure absorbs 66.05% of total cash sources. These two jointly make the cash sources almost eroded in spite of cash contribution by operating profit (51.05%) and by creditors (7.63%).

In view of arranging cash and for better profitability, inventory management must be improved and to take the benefit of financial leverage, additional debentures could be issued.

Freshold Droperty Ale

Working Notes:

OF THE PARTY OF THE PARTY.	Rs.		Rs.
To Balance b/d To Capital Reserve (Profit)	1,62,000	By Bank (Sale— Balancing figure)	15,000
On sale 7,000 On revaluation 1,02,000	1,09,000	By Balance c/d	2,56,000
	2,71,000		2,71,000

(2)

Plant & Machinery A/c

	Rs.	e com near thankacha na ma	Rs.
To Balance b/d To Bank (Purchase— Balancing figure)	2,58,000 72,000	By Sale of Machinery (Ori- ginal cost 5000×100/20) By Balance c/d	25,000 3,05,000
	3,30,000	the inscionary axis arrange is 19	3,30,000

(3)

Sale of Machinery A/c

	Rs.		Rs.
To Plant & Machinery To Profit & Loss (Profit on sale)	25,000 1,800	By Provision for Deprecia- tion (Accumulated depre- ciation on Machinery sold)	20,000
	ver authority)	By Bank (Sale)	6,800
	26,800	907 19067	26,800

(4)

Provision for Depreciation A/c

	Rs.		Rs.
To Sale of Machinery	20,000	By Balance b/d	88,500
(25,000 – 5,000) To Balance c/d	1,02,700	By Depreciation (Current year's Depreciation)	34,200
	1,22,700	Committee of agent for	1,22,700

(5)

10% Debentures A/c

	Rs.		Rs.
To Balance c/d	60,000	By Balance b/d	40,000
	8 0 F	By Debenture discount [(60,000 - 40,000)×2%]	400
	SHAME IN	By Bank (Balancing figure)	19,600
	60,000		60,000

(6)

Profit & Loss A/c

	Rs.		Rs.
To Depreciation	34,200	By Balance b/d	40,000
To Reserve for replacement of machinery (45,000 – 40,000)	5,000	By Profit on sale of machinery	1,800
To Debenture discount To Balance c/d	400 35,000	By Operating profit (Balancing figure)	32,800
	74,600		74,600

4.10 Summary

Preparation of cash flow statement is made for showing effects of various cash transactions classifying them distinctly how the financial position of a firm changes over a period of time due to its operating activities, investing activities and financing activities of an entity on cash and cash equivalents. It also establishes the relationship between net profit and the change in the cash position of a firm. Thus, cash flow statement is considered as one of the measures of liquidity. Different interested parties are highly interested in getting cash flow information rather than information that are available in the funds flow statement. Moreover, AS-3 made the preparation of cash flow statement mandatory for accounting period commencing on or after 1.4.2001 in respect of (a) listed companies or companies whose shares and debentures are in the process of listing on a recognised stock exchange in India; (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

4.11 Exercises

Problem 1:

Following are the Balance Sheets of Piano Ltd. as on December 31, 2004 and as on December 31, 2005 :

Liabilities	31.12.04	31.12.05	Assets	31.12.04	31.12.05
NG SECTION TO BE THE SECTION OF THE	Rs.	Rs.		Rs.	Rs.
Equity Share Capital	1,00,000	1,50,000	Freehold Property	1,10,000	1,30,000
Security Premium	15,000	35,000	Plant & Machinery	1,20,000	1,51,000
Profit & Loss A/c	28,000	70,000	Furniture	24,000	29,000
8% Debentures	70,000	30,000	Stock	37,000	51,000
Bank Overdraft	14,000		Debtors	43,000	44,000
Creditors	34,000	48,000	Bank		16,000
Proposed Dividend	15,000	20,000	Premium on redemp-		- orthoga
Prov. for Dep. on :	Number of the last		tion of Debentures	_	1,000
Plant	45,000	54,000	Break Transport	413	40 H A
Furniture -	13,000	15,000	ung de l'Estate	bit held	
	3,34,000	4,22,000		3,34,000	4,22,000

Additional information :

- 1. There had been no disposal of Freehold Property in the year.
- 2. The Machine which had cost Rs.8,000 and in respect of which Rs.6,000 depreciation had been provided was sold for Rs.3,000 and Furniture which cost Rs.5,000 in respect of which of Rs.5,000 had been provided were sold for Rs.1,000. The profits or losses on these transactions had been dealt with through the Profit & Loss A/c.
- 3. The actual premium on redemption of Debenture was Rs. 2,000 of which Rs. 1,000 had been written off to the Profit & Loss A/c.
- No interim dividend has been paid.

You are asked to prepare a cash flow statement for the year ended December 31, 2005 and on the basis of the cash flow statement prepared by you, comment on the financial position of the company.

Answer: Net cash from operating activities Rs.84,400; Net cash used in investing activities Rs.65,000 and Net cash from financing activities Rs.10,600.

Andrews I Land

Problem 2:

Following are the Balance Sheets of Patel Company Ltd. as on March 31, 2004 and as on March 31, 2005 :

Liabilities	31.3.04	31.3.05	Assets	31.3.04	31.3.05
	Rs.	Rs.	Sales or Sales or I	Rs.	Rs.
Equity Share Capital	3,00,000	3,50,000	Goodwill	1,00,000	89,000
7% Pref. Sh. Capital	1,50,000	1,00,000	Land & Building		
Security Premium	20,000	25,000	at cost	2,50,000	2,20,000
Capital Reserve	-	20,000	Plant & Machinery	80,000	2,00,000
General Reserve	40,000	75,000	Investment	20,000	35,000
Profit & Loss A/c	30,000	73,000	Stock	77,000	1,00,000
8% Debentures	50,000	- 50,000	Debtors	1,40,000	1,70,000
Creditors	55,000	83,000	Bills Receivable	20,000	30,000
Bills Payable	20,000	16,000	Cash at Bank	16,000	11,000
Provision for Tax	40,000	50,000	Cash in Hand	9,000	7,000
Proposed Dividend	42,000	50,000	Preliminary Exp.	35,000	30,000
THE REPORT OF THE PARTY OF THE	7,47,000	8,92,000	ocogniti and tanja	7,47,000	8,92,000

Additional information:

- One piece of land was sold at a profit and the profit was transferred to Capital Reserve.
- One Machine was sold for Rs.15,000 (written down value on the date of sale was Rs.18,000.
- 3. Depreciation charged on Plant & Machinery amounted to Rs.16,000.
- Dividend of Rs.4,000 was received from Investment of which Rs.2,000 was credited to Investment A/c being dividend declared from pre-acquisition profit.
- Actual amount of dividend and taxes paid were Rs. 35,000 and Rs. 38,000 respectively.

You are required to prepare a Cash Flow Statement for the year ending on March 31, 2005 and comment on the financial position of the company.

Answer: Net cash from operating activities Rs.1,29,000; Net cash used in investing activities Rs.1,02,000 and Net cash used in financing activities Rs.34,000.

4.12 Questions

- 1. What is cash flow statement? What does it convey? Why is it necessary?
- 2. Why is cash flow statement superior over the funds flow statement? Distinguish between cash flow statement and funds flow statement.
- 3. Do the preparation of cash flow statement is mandatory in India? How would you prepare it as per AS-3? What special advantages can be derived by preparing such a statement?
- 4. How can you comment on the financial position of a company on the basis of cash flow statement?
- 5. Mention the correct answer:
 - If the net operating profit of a business is Rs.90,000 and debtors have decreased during the year by Rs.30,000, cash from operations equals (a) Rs.90,000; (b) Rs.1,20,000; (c) Rs. 60,000.
 - ii. Sale of long-term investments at a profit (a) increase the cash; (b) decrease the cash; (c) has no effect on cash.
 - Payment of income tax for which a provision has been made (a) increase the cash; (b) decrease the cash; (c) has no effect on cash.

Answers: i. (c), ii. (a), iii. (b).

4.13 Suggested Readings

- 1. Banerjee, B: Financial Management and Policy, World Press Pvt. Ltd.
- 2. Khan, M. Y. & Jain, P. K: Financial Management, Tata McGraw-Hill Publishing Company Ltd.
- 3. Pandey, I. M: Financial Management, Vikas Publishing House Pvt. Ltd.
- 4. The Institute of Chartered Accountants of India: Accounting Standard-3.

Unit 5 Liquidation of Companies

Structure

- 5.0 Objective
- 5.1 Introduction
- 5.2 Meaning of Liquidation
- 5.3 Mode of Liquidation
 - 5.3.1 Compulsory Winding Up
 - 5.3.2 Voluntary Winding Up
 - 5.3.3 Winding up Subject to the supervision of Court
- 5.4 Statement of Affairs
- 5.5 Procedure of the Preparation of Statement of Affairs
- 5.6 Deficiency or Surplus Account
- 5.7 Preferential Creditors
- 5.8 Overriding Preferential Payments
- 5.9 Liquidator's Final Statement of Account
- 5.10 Some important items
- 5.11 Summary
- 5.12 Exercises
- 5.13 Questions
- 5.14 Suggested Readings

5.0 Objective

By the time you have gone through this unit you would be able to :

- understand the legal provisions of liquidation with its types according to the Companies Act, 1956; and
- know the procedure of the preparation of Statement of Affairs (by the company) and Liquidator's Final Statement of Account (by the liquidator).

5.1 Introduction

Liquidation of companies is a legal process by which the corporate life of any company comes to an end. The types of liquidation are compulsory, voluntary and under the supervision of Court. The accounting for liquidation requires the preparation of Statement of Affairs, Deficiency or Surplus Account and Liquidator's Statement of Account. The procedure of the preparation of these three statements along with legal provisions is explained in the appropriate place.

5.2 Meaning of liquidation

A company is an artificial person, which is the creation of law. The life of a company can come to an end only through the process of law. The process of law undertaken to bring end the life of a company is known as *liquidation* or *winding up*. It is not necessary that only solvent company be liquidated. Sometimes, also it is essential to liquidate solvent and prosperous company. The Companies Act, 1956 lays down the procedure by which a company can be liquidated. When the winding up order is made or a provisional liquidator is appointed by the Court, the liquidator will take into his custody or under his control all the property of the company and its effects and actionable claims under section 456. The job of realising various assets and paying various liabilities through a legal way performed by a person is called liquidator. The appointment of liquidator is dependent on the mode of liquidation.

5.3 Mode of liquidation

There are three modes by which a company can be liquidated. They are discussed briefly in the paragraphs that follow.

5.3.1 Compulsory Winding Up

This is also called winding up by the Court. Section 433 of the Companies Act provides that a company may be wound up by the Court (a) if the company passes a special resolution to this effect; (b) if the company defaults in delivering the statutory report to the Registrar or in holding the statutory meeting; (c) if the company does not commence its business within a year from its incorporation or suspends its business for a whole year; (d) if the number of its members falls below 7 in case of a public company and 2 in case of a private company; (e) if the company is unable to pay its debts; and (f) if the Court is of opinion that the company should be wound up.

5.3.2 Voluntary Winding Up

There are two types of voluntary winding up, viz. (i) Mcmbers' voluntary winding up—It takes place when a declaration of company's solvency, verified by an affidavit, is made by the majority of the directors to the Registrar that the company will pay its debts within 3 years from the commencement of winding up; and (ii) Creditors' voluntary winding up—when a declaration of solvency is not filed to the Registrar and the creditors have the dominating control over the proceedings of the winding up.

5.3.3 Winding up subject to the supervision of Court

When the Court orders that the voluntary winding up should continue under its supervision and on terms and conditions which the Court decides.

5.4 Statement of Affairs

When a company is wound up by the order of the Court or when the official liquidator has been appointed by the Court as provisional liquidator, the officers and the directors of the company must submit to the official liquidator within 21 days or within such extended time, not exceeding 3 months, as the official liquidator or the Court may allow from the date of winding up order a statement which is known as Statement of Affairs. The statement of affairs has to be prepared even in case of voluntary winding up. It always remains open to inspection by any person, claiming in writing to be a creditor or contributory. It must be properly verified by an affidavit and should be prepared in Form 57 contained in the Companies (Court) Rules, 1956. The Statement of Affairs discloses the estimated deficiency on account of expected realisable value of assets and its possible disbursements towards various liabilities on the basis of priority of receiving payments within stipulated date not exceeding 3 months from the date of winding up order. Practically, the company prepares this statement after the winding up order but before the actual disposal of assets and payment of liabilities.

5.5 Procedure of the Preparation of Statement of Affairs

The procedure of the preparation of Statement of Affairs is furnished hereunder:

 Include all assets not specifically pledged (as per list A). The amount expected to be realised from individual asset including unpaid calls would be extended to the 'estimated realisable value' column.

- 2. Include all assets specifically pledged (as per list B). The amount expected to be realised from individual asset would be compared with the amount due to the secured creditor(s) concerned. Surplus, if any, is to be extended to both the 'surplus carried to last column' and 'estimated realisable value' column. A deficit arising out of the amount due to the secured creditors exceeding the amount realisable from the asset is to be added to unsecured creditors.
- The total of assets is available for all creditors excluding secured creditors
 as already covered by assets specifically pledged would be the sum of the
 amounts as in paragraphs (1) and (2) above.
- 4. Find the 'Summary of Gross Assets'. The amount would be the total of 'estimated realisable value of assets not specifically pledged' and 'other assets (gross estimated realisable value of assets specifically pledged'. The amount of the gross assets would be shown in the main body of the statement of affairs but not in the 'estimated realisable value' column.
- Place the amount of secured creditors to the extent to which claims are estimated to be covered by assets specifically pledged in the 'Gross Liabilities' column only (as per list B).
- 6. From the total assets available, the following should be placed in the 'Gross Liabilities' column and also should be deducted one by one and struck the balance at each stage:
 - a. Preferential creditors (as per list C);
 - b. Debenture-holders having a floating charge (as per list D);
 - c. Unsecured creditors (as per list E);
 - d. Paid up Preference share capital (as per list F); and
 - e. Paid up Equity share capital (as per list G).

In case of minus balance, there would be deficiency as regards members, otherwise there would be surplus (as per list G).

5.6 Deficiencies or Surplus Account

A Deficiency or Surplus Account (as per list G) is prepared, which explains in brief how the deficiency or surplus as shown in the statement of affairs has arisen. The period covered by this account must commence on a date not less than 3 years before the date of winding up order or from the date of formation of the company if the life of its existence is less than 3 years unless the official liquidator otherwise agrees.

5.7 Preferential Creditors

Section 530 mentions that some creditors are to be paid in priority to unsecured creditors or creditor having floating charge. These creditors are called *Preferential Creditors* and include the following:

- All revenues, taxes, cesses and rates due and payable by the company within 12 months next before the commencement of the winding up;
- 2. All wages or salaries of any employee due for the period not exceeding 4 months within 12 months next before the commencement of winding up and any compensation payable to any workmen under the Industrial Dispute Act, 1947. The amount payable (relating to lay off and discharge of workers) to an employee should not exceed Rs.1000;
- 3. All accrued holiday remuneration becoming payable to any employee on account of winding up;

Note: Where a person advances money for the purpose of making preferential payments under (1) and (2) above, he will be treated as preferential creditor, provided the money actually used.

- All sums due in respect of any compensation or liability under the Workmen's Compensation Act, 1923;
- Unless the company is being wound up voluntarily for the purpose of reconstruction, all contributions payable during 12 months next before the commencement of winding up under the State Insurance Act, 1948, or any other law for the time being in force;
- All sums due to any employee from a provident fund, pension fund, gratuity fund or any other fund for the welfare of the employees maintained by the company;
- 6. The expenses of any investigation held in accordance of section 235 or 237 in so far as they are payable by the company.

5.8 Overriding Preferential Payments

As per amendment of the Companies Act, a new category of preferential payments is to be made in priority to all other debts. These include:

- 1. Dues to workmen, and
- Debts to secured creditors to the extent such debts rank pari passu with such dues.

Preparation of Statement of Affairs

Illustration 1:

Metal Ltd. went into liquidation on March 31, 2005. The following balances are extracted from the books on that date:

Liabilities	Rs.	Assets	Rs.
Capital:	Dilling the let	Buildings	1,50,000
50,000 Equity Shares of	O DESTRUCCIO	Plant & Machinery	2,10,000
Rs.10 each	5,00,000	Stock-in-trade	95,000
Debentures (secured by		Book Debts 75,000	
floating charge)	2,00,000	Less: Provision 10,000	65,000
Bank Overdraft	30,000	Calls in Arrears	1,00,000
Creditors	40,000	Cash on hand	10,000
	SMITUSELS	Profit and Loss Account	1,40,000
	7,70,000	AF 55 THOLE AT 10 3188	7,70,000

Plant & Machinery and Buildings are valued at Rs.1,60,000 and Rs.1,20,000 respectively. On realisation, losses of Rs.25,000 are expected on stock, Book Debts will realise Rs.70,000. Calls in arrears are expected to realise 90%. Bank overdraft is secured against Buildings, Preferential Creditors for taxes and wages are Rs.6,000 and Miscellaneous Expenses outstanding Rs.2,000.

Prepare a Statement of Affairs to be submitted to the meeting of creditors.

Solution: As per Form 57

Metal Ltd. (in liquidation) Statement of Affairs as on March 31, 2005

telle ter	nations to constant to a state of the constant	Estimated realisable value
		Rs.
	Assets not specifically (as per list A):	11195
	Plant & Machinery	1,60,000
	Stock-in-trade 194 assessment of the introduction	70,000
	Book Debts	70,000
	Unpaid Calls (Calls in Arrear)	90,000
		10,000
	Cash on hand	4,00,000

	Assets specifically pledged (as per list B):	AT THE SAME
	(a) (b) (c) (d)	
en hall	Estimated Due to Deficiency Surplus	off a
	Realisable secured ranking as carried to	
	value creditors unsecured last column	
	Rs. Rs. Rs.	
0.00,00.1	Buildings 1,20,000 ag 30,000 bag 0 + 58 to 90,000 00	
	Estimated surplus from assets specifically pledged	90,000
	Estimated total assets available for Preferential Creditors, Debenture-holders secured by floating and unsecured creditors	4,90,000
	Summary of Gross Assets (e):	
	Gross realisable value of assets specifically	
0.00,02.1	pledged 1,20,000	
15,000	Other assets 4,00,000	
20,000	Gross Assets 5,20,000	
(f)	Liabilities	157-141
Gross Liabilities	(to be deducted from surplus or added to deficiency as the case may be)	
Rs. 30,000	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged	Mani
(4,000		oinatt val
6,000	Preferential Creditors (as per list C):	
6,000	Creditors for taxes and wages	6,000
	Estimated balance of assets available for Debenture- holders secured by a floating charge and unsecured creditors	4,84,000
2,00,000	Debenture-holders secured by a floating charge (as per list D)	2,00,000
	Estimated surplus as regards Debenture-holders	2,84,000
34,000	Unsecured Creditors (as per list E)	34,000
2,70,000	Estimated surplus as regards creditors [(f) - (e)]	2,50,000
	Issued and Called up Capital:	
	Preference Shares (as per list F) Nil	
	5,000 Equity Shares of Rs.100 each fully paid	
not, s	(as per list G) <u>5,00,000</u>	5,00,000
200	Estimated deficit as regards members	2,50,000

Preparation of Statement of Affairs and Deficiency Account

Illustration 2:

The following particulars were extracted from the books of Silver Ltd. as on March 31, 2005 on which date a winding up order was made :

Equity Share Capital:	Rs.
2,000 Shares of Rs.100 each, Rs.50 paid up	1,00,000
6% Preference Share Capital:	
2,000 Shares of Rs.100 each fully paid	2,00,000
6% First Mortgage Debentures, secured by a floating charge on the whole of the assets of the company, exclusive of the uncalled capital	1.50.000
	1,50,000
Fully Secured Creditors (value of securities, Rs.35,000)	35,000
Partly Secured Creditors (value of securities, Rs.10,00)	20,000
Preferential Creditors for rates, taxes, wages etc.	6,000
Unsecured Creditors	70,000
Bills Payable	1,00,000
Bank Overdraft	10,000
Bills Receivable in hand	15,000
Bills Discounted (one bill for Rs.10,000 known to be bad)	40,000
Book Debts—Good	10,000
-Doubtful (estimated to produce 40%)	7,000
—Bad	6,000
Land & Building (estimated to produce Rs.1,00,000	1,50,000
Stock-in-trade (estimated to produce Rs.40,000)	50,000
Machinery, Tools etc. (estimated to produce Rs.2,000)	5,000
Cash in hand	2,100
Prepare Statement of Affairs and Deficiency Account	

Solution:

In order to find out the position of Reserve and Surplus as on March 31, 2005 the following Trial Balance is prepared:

Debit balances	Amount	Credit balances	Amount
	Rs.		Rs.
Land & Building	1,50,000	Equity Share Capital	1,00,000
Machinery, Tools etc.	5,000	6% Pref. Share Capital	2,00,000
Investments	45,000	6% Mortgage Debentures	1,50,000
Stock-in-trade	50,000	Fully Secured Creditors	30,000
Book Debts	23,000	Partly Secured Creditors	20,000
Bills Receivable	15,000	Preferential Creditors	6,000
Cash in hand	2,100	Unsecured Creditors	70,000
Profit & Loss (Balancing	3,95,900	Bills Payable	1,00,000
figure)		Bank Overdraft	10,000
	6,86,000		6,86,000

Silver Ltd. (in liquidation)

Statement of Affairs as on March 31, 2005

E STATE OF THE STA	F	stoggalika njek	mot a Sta	native sticks		Estimated to realise
	Assets not specifically pledged (as per list A):					
	Cash in	hand				2,100
	Land &	Building				1,00,000
	Machine	ery, Tools et	c.			2,000
	Stock-in	n-trade				40,000
	Book Debts					
	Bills Receivable					
	Assets specifically pledged (as per list B):					1,71,900
		(a)	(b)	(c)	(d)	
		Estimated	Due to	Deficiency	Surplus	
		Realisable	Secured	ranking as	carried to	
	2,000,000	value	creditors	unsecured	last column	
	100	Rs.	Rs.	Rs.	Rs.	
	Investments	35,000	30,000		5,000	
2	Investments	10,000	20,000	10,000		
	MENS SI	45,000	50,000	10,000	5,000	

	Estimated surplus from assets specifically pledged	_5,000
ns at a	Estimated total assets available for Preferential Creditors, Debenture-holders secured by a floating charge and	ribio iil. nymllut sii
IngomA 1	unsecured creditors	1,76,900
	Summary of Gross Assets (e):	
	Gross realisable value of assets specifically	A Shint
100000	pledged 45,000	blackmen.
an e i	Other assets 1,71,900 Gross Assets 2,16,900	decimental and
		Stock and
(f)	Liabilities , , , , , , , , , , , , , , , , , , ,	Buck Date
Gross Liabilities	(to be deducted from surplus or be added to deficiency as the case may be)	Sills Rood of
Rs.	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets	A nima.
40,000	specifically pledged	Countries
6,000	Preferential Creditors (as per list C):	6,000
	Estimated balance of assets available for Debenture- holders secured by a floating charge and unsecured	*
- Street Street	creditors	1,70,900
1,50,000	Debenture-holders secured by a floating charge (as per list D)	_1,50,000
	Estimated surplus as regards Debenture-holders	20,900
	Unsecured Creditors (as per list E):	
10,000	Unsecured balance of partly secured creditors 10,000	
70,000	Unsecured Creditors 70,000	
1,00,000	Bills Payable 1,00,000	
10,000	Bank Overdraft 10,000	
10,000	Bills Discounted	2,00,000
3,96,000	Deficiency as regards creditors	1,79,100
	Issued and Called up Capital :	
	2,000 6% Pref. Shares of Rs. 100 each fully paid (as per list F) 2,00,000	
	2,000 Equity Shares of Rs. 100 each, Rs. 50 paid up (as per list G)	3,00,000
	Estimated deficiency as regards members (as per list H)	4,79,100

List H-Deficiency Account

	Bist 11-Deficiency Account		
A. It	ems contributing to deficiency (or reducing surplu	s):	Rs.
1.	Excess of capital and liabilities over assets on 1. (at least 3 years before the date of winding up o		Nil
2.	Net dividends and bonuses declared during the p from 1.4.2002 to 31.3.2005	eriod	Nil
3.	Net trading losses after charging depreciation, ta interest on Debentures, etc. for the same period	xation,	3,95,900
4.	Losses other than trading losses		Nil
5.	Estimated losses now written off or for which purpose of preparing the		0(30,
	Land & Building (1,50,000 - 1,00,000)	50,000	(udana)
	Machinery, Tools etc. (5,000 - 2,000)	3,000	
	Stock-in-trade (50,000 - 40,000)	10,000	
	Book Debts (23,000 - 12,800)	10,200	
	Bills Discounted	10,000	83,200
6.	Other items contributing to deficiency		Nil
(A	70, 50 X 1 = 000,00 = 1 Tota	l (A)	4,79,100
B. It	ems reducing deficiency (or contributing to surplu	ıs) :	Smooth.
7.	Excess of assets over capital and liabilities on 1	.4.2002	Nil
8.	Net trading profits after charging depreciation, taxation, interest on Debentures, etc. during the period from 1.4.2002 to 31.3.2005		Nil
9.	Profits and income other than trading profits during the same period		Nil
10	Other items reducing deficiency		Nil
	Total	al (B)	Nil
De	ficiency as shown by the Statement of Affairs (A	– B)	4,79,100
E1 - E1/5	and the state of t		The second second

Illustration 3:

From the following particulars prepare a Statement of Affairs and Deficiency Account for submission to the Official Liquidator of Copper Ltd. which into liquidation on December 31, 2005.

30,000 Equity Shares of Rs.10 each, Rs.8 paid		2,40,000
10,000 6% Preference Shares of Rs.10 each fully paid	1,00,000	
Less : Calls in Arrear (expected to produce)	5,000	95,000
6% Debentures having a floating charge on the assets (interest paid up to June 30, 2005)	in shends on La 2002 to	1,00,000
Mortgage on Land & Buildings		80,000
Trade Creditors		2,44,500
Owing for wages		20,000
Secretary's salary @ Rs.15,000 p.m. owing		30,000

Assets	Estimated to produce	Book value
und he leave of	Rs.	Rs.
Land & Building	1,30,000	1,20,000
Plant Plant	1,30,000	2,00,000
Tools (and the of pour distance to	4,000	2,00,000
Patents 2001 a Faur 45 Miles Ph. M. 1993	30,000	50,000
Stock	74,000	87,000
Investments (in the hands of bank for an	100° 40 mo	n botten
overdraft of Rs. 1,90,000)	1,70,000	1,80,000
Book Debts	60,000	90,000

On December 31, 2000 the Balance Sheet of the company showed a General Reserve of Rs. 40,000 accompanied by a debit balance of Rs. 25,000 in the Profit & Loss Account. In 2001 the company made a profit of Rs. 42,000 and declared a dividend of 10% on Equity Shares. The company suffered a total loss of Rs. 1,09,000 besides loss of stock due to fire of Rs. 40,000 during 2002, 2003 and 2004. For 2005 accounts were not made up. The cost of winding up is expected to be Rs. 15,000.

Solution:

To find out the position of Reserve and Surplus on December 31, 2005 a Trial Balance is prepared as below:

Trial Balance as on December 31, 2005

	Dr.	Cr.
Particulars	Amount	Amount
La Company of Company	Rs.	Rs.
Equity Share Capital		2,40,000
6% Preference Share Capital	THUS W	1,00,000
Calls in Arrear	5,000	
Mortgage on Land & Building	Self and self-self-self-self-self-self-self-self-	80,000
Land & Buildings	1,20,000	
6% Debentures including interest of Rs. 3,000	- Talketia kija	
(from 1.7.2005 to 31.12.2005)		1,03,000
Trade Creditors		2,44,500
Owing for wages	W =	20,000
Secretary's salary owing		30,000
Bank Overdraft (secured against investments)	be memerals.	1,90,000
Investments	1,80,000	
Stock	87,000	
Book Debts	90,000	
Plant	2,00,000	
Tools	20,000	
Patents	50,000	
Profit & Loss Account (Balancing figure)	2,55,000	
100 (100	10,07,500	10,07,500

To determine the trading loss for the year 2005, Reserve and Surplus Account is prepared as below:

Dr.	Reserve and Surplus Account	Cr.
	The state of the s	PERSONAL PROPERTY.

	Particulars NAME AND	Amount (Rs.)	Particulars	Amount (Rs.)
То	Balance b/d (Dr. balance in the Profit & Loss A/c		By Balance b/d (General Reserve on 1.1.2001	40,000
То	on 1.1.2001 Income-tax for 2001	25,000	By Profit before tax for 2001 :	
	(assume 30%)	18,000	After tax profit 42,000	minpel 1
То	Dividend for 2001 Preference 5,700 Equity 24,000	29,700	By Balance c/d (Dr. balance in the Profit & Loss A/c	60,000
То	Loss of stock by fire for		on 31.12.2005	2,55,500
То	2002, 2003 and 2004 Trading losses for 2002	40,000	Sqnabhull .	D. Lm.J.
2	2003 and 2004	1,09,000	ST to Amerika ambaiani assump	
То	Trading loss for 2005	1,33,800	17 DOS SLAR OF BOXES FOR M	
	(Balancing figure)		netter	al make s
	80,00	3,55,550	in source	3,55,550

Steel Ltd. (in liquidation)

Statement of Affairs as on December 31, 2005

		Estimated realisable value
	Assets not specifically pledged (as per list A):	Rs.
13.24	Plant	1,30,000
-	Tools	4,000
	Patents	30,000
	Book Debts	60,000
	Stock	74,000
1.33	Unpaid Calls	5,000
1	etok Dilyonayawa i	3,03,000

	Assets specif	ically pledge	ed (as per li	st B) : 1016	Consumed Lex	
	1000,85	(a)	(b)	(c)	(d)	
2,90,500	1000,000 1012,112,5	Estimated Realisable	Due to Secured	Deficiency ranking as	Surplus carried to	
84,500		value Rs.	creditors Rs.	unsecured Rs.	last column Rs.	nic tan
	Land & Buil	ding			in an allowed	
		1,30,000	80,000	to the same	50,000	
	Investments	1,70,000	1,90,000	20,000	niousi m insis	
		3,00,000	2,70,000	20,000	50,000	
000 FEED	Estimated su	rplus from a	ssets specif	ically pledged	ď	50,000
	Estimated to	tal assets av	ailable for I	referential C	reditors,	
			d by a float	ting charge a	nd	
2.51	unsecured cr				or to hand grand	3,53,000
	Summary of					
25,000	Gross realisa	ble value of	assets spec	ifically pledg	William Commence of the Commen	
*					3,00,000	
0017 055	Other a				3,03,000	
000	Gross A	Assets	Liverph of	inner site	6,03,000	
(f)			Liabilities		unsdall bu ra	
Gross Liabilities	(to be deducted as the case r		plus or add	ed to deficier	ncy ill pallu a	rendi 4
2,50,000	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets specifically pledged					
	Preferential (000,000	
20.000	whose wages	s are due for	4 months	ere 20 worke preceding the		100 h
20,000	of this state			9	0 - 000034	20,000
000,041	holders secur	red by a float	ating charge	for Debentu and unsecur	7.5275	3,33,000
1,03,000	Debenture-ho (as per list I		d by a floa	ting charge	itelia contra	1,03,00
U08, 88,20	Estimated su	rplus as reg	ards Debent	ure-holders		2,30,000

Allerin	Unsecured Creditors (as per list E):	Assets about	
20,000	Unsecured balance of Secured Creditors	20,000	
30,000	Secretary's salary owing	30,000	
2,44,500	Trade Creditors	2,44,500	2,94,500
6,67,500	Estimated deficiency as regards creditors [(f) - (e)]		64,500
	Issued and Called up Capital:		
	10,000 6% Preference Shares of Rs.10 each		
	(as per list F)	1,00,000	
	30,000 Equity Shares of Rs.10 each, Rs. 8 paid		18
	(as per list G)	2,40,000	
			3,40,000
	Estimated deficiency as regards members		4,04,500

List H-Deficiency Account

	List H-Deficiency Accou	1726	
A. It	ems contributing to deficiency (or reducing sur	rplus) :	Rs.
1.	Excess of capital and liabilities over assets of (Debit balance in the Profit & Loss A/c on 1		25,000
2.	Net dividends and bonuses declared during the from 1.1.2001to 31.12.2005	ne period	29,700
3.	Net trading losses after charging depreciation interest on Debentures, etc. (1.09,000 + 1,33,		2,42,800
4.	Losses other than trading loss or for which p has been made during the same period (loss destroyed by fire)		40,000
5.	Estimated losses now written off or for which has been made for the purpose preparing this	statement :	2.50 000
	Tools (20,000 – 4,000)	70,000 16,000	
	Stock (87,000 – 74,000)	13,000	
ine	Investments (1,80,000 – 1,70,000) Book Debts (90,000 – 60,000)	10,000 <u>30,000</u>	1,59,000
6.		ार्थ हमा का बा	Nil
	Total	(A)	4,96,500

B. Items reducing deficiency (or contributing to surplus):	WEST WITH THE SE
7. Excess of assets over capital and liabilities on 1.1.2001 (General Reserve on 1.1,2001)	40.000
 Net trading profits after charging depreciation, taxation, interest on Debentures, etc. during the period from 1.1.2001 to 31.12.2005 	42,000
 Profits and income other than trading profits during the same period (expected profit on realisation of Land & Buildings) 	10,000
10. Other items reducing deficiency	Nil
Total (A – B)	92,000
Deficiency as shown by the Statement of Affairs (A - B)	4,04,500

5.9 Liquidator's Final Statement of Account

The functions of the liquidator are to realise the assets of the company and to distribute the amounts among those who have a rightful claim to it. In order to discharge his duties as laid down in the Companies Act, 1956 he has to prepare a summary Cash Book showing therein realisation of assets and payment to those who have a rightful claim on the disbursements of the amounts. The summary Cash Book prepared by the liquidator after the liquidation started is known as "Liquidator's Statement of Account or Liquidator's Final Statement of Account". Moreover, he has to submit the statement to the Court in case of compulsory liquidation and to the company in case of voluntary liquidation. It is only a statement although presented in the form of an account. Naturally, no double entry is involved in its preparation.

In view of carrying out the disbursements, the following is the order, which will be followed by the liquidator:

- Secured Creditors—They should be paid up to their claim or up to the
 amount realised by the sale of assets held by them, whichever is lower.
 Again, creditors themselves may sell the assets held by them and return the
 surplus, if any, to the liquidator after meeting their claim. In this situation,
 only the surplus is shown as receipt without showing the payment to secured
 creditors in the Liquidator's Statement of Account.
- 2. Legal Charges.
- 3. Liquidator's remuneration.
- 4. Cost of winding up.

- 5. Preferential Creditors.
- Debenture-holders or other creditors having a floating charge on the assets of the company.
- Unsecured Creditors—This may include liability for dividend or amounts due to shareholders on account of profits. In this case, dividend is to be paid after the outsiders are completely paid off.
- 8. Preference Shareholders.
- 9. Equity Shareholders.

5.10 Some Important Items

Necessary attention is required to be given for the following items :

- 1. Liquidator's Remuneration—In case of compulsory liquidation, the remuneration of the liquidator is fixed by the Court, while the remuneration of the liquidator is fixed by the meeting which appoints the liquidator in case of voluntary winding up. The remuneration once fixed cannot be increased. Liquidator's remuneration usually consists of a commission on assets disposed of plus a commission on the amounts paid to unsecured creditors.
- 2. Debenture Interest—Where the company is solvent, debenture interest should be paid up to the date of payment. But, debenture interest should be paid up to the date of liquidation when the company is insolvent. The same rule is also applicable to other creditors as to the payment of interest. A company is treated as insolvent if it cannot pay all its creditor.
- 3. Arrear Preference Dividend—The position of arrear preference dividend is summarised as below:
 - (a) The question of arrear does not arise in case of non-cumulative Preference Shares. But, in case of shares are not specifically mentioned as noncumulative, they should be treated as cumulative.
 - (b) No dividend is payable for any period falling after the commencement of liquidation.
 - (c) If preference dividend has been declared but not paid, then that should be paid as debt and not as an arrear.
 - (d) If the preference dividend has not been declared for one or more years, then arrear preference dividend will be paid provided there is a surplus after payment of preference share capital first and then equity share capital, unless otherwise specifically stated in the Articles of Association of the company.

Preparation of Liquidator's Statement of Account

Illustration 4:

The following particulars relate to Copper Ltd., which has gone into voluntary liquidation on March 31, 2005. You are required to prepare the Liquidator's Statement of Account, allowing for his remuneration @ 3% on the amount realised, and 2% on the amount distributed to unsecured creditors:

	Rs.
Preferential Creditors	10,000
Unsecured Creditors	32,000
Debentures	10,000
The assets realised the following sums:	
Land and Building	20,000
Plant and Machinery	18,670
Fixtures and Fittings	1,000
The state of the s	

The liquidation expenses amounted to Rs.1,000.

Solution:

Liquidator's Statement of Account for the period ending on March 31, 2005

Receipts	Amount	Payments	Amount
To Assets realised:	Rs.		Rs.
Land & Building	20,000	By Liquidator's Remuneration	1,534
Plant & Machinery	18,700	By Liquidation Expenses	1,000
Fixtures & Fittings	1,000	By Preferential Creditors	1,00,000
	e with the	By Debenture holders (assume having a floating charge)	10,000
		By Unsecured Creditors	17,166
	39,700		39,700

Working Note:

1.	Liquidator's Remuneration		Rs.
	Assets realised		39,700
	Less: 3% on assets realised	1,191	
	Liquidation Expenses	1,000	
	Preferential Creditors	10,000	
	Debenture-holders having a floating charge	10,000	22,191

Amount available for unsecured creditors subject to remuneration	17,509
Less: Payment to Unsecured Creditors (17,509 × 100/102)	17,166
Remuneration on Unsecured Creditors	343
Total remuneration (1,191 + 343)	1,534

Illustration 5:

The Balance Sheet of Picture Ltd. as on March 31, 2005 is given below:

Liabilities	Amount	Assets	Amount
Share Capital:	Rs.	Chell Wald	Rs.
3,000 6% Pref. Shares of		Land & Buildings	1,50,000
Rs.100 each fully paid	3,00,000	Plant & Machinery	3,75,000
1,500 Equity Shares of		Patents	60,000
Rs.100 each, Rs.75 paid	1,12,500	Stock	82,500
4,500 Equity Shares of		Sundry Debtors	1,65,000
Rs.100 each, Rs.60 paid	2,70,000	Cash at Bank	45,000
5% Debentures (having a		Profit & Loss Account	1,80,000
floating charge on all assets)	1,50,000		1000
Interest Due on Debentures	7,500	Talis is a sampling it	DESK!
Creditors	2,17,500	turnis continu	
	10,57,500	At 1 STROET & STROET	10,57,500

The preference dividends were in arrear for two years. Creditors include a loan of Rs.75,000 on the mortgage of Land & Buildings. The assets were realised as follows:

Land & Buildings Rs.1,80,000; Plant & Machinery Rs.3,00,000; Patents Rs.46,000; Stock Rs.89,000 and Sundry Debtors Rs.1,20,000.

The expenses of liquidation amounted to Rs.16,755. The liquidator is entitled to a commission of 3% on all assets realised except Cash at Bank and a commission of 2% on amounts distributed among unsecured creditors. Preferential creditors amount to Rs.22,500. All payments were made on September 30, 2005.

Prepare the Liquidator's Statement of Account.

Solution:

Liquidator's Statement of Account from 1.4.2005 to 30.9.2005

Receipts	Amount	Payments	Amount
To Realisation of Assets:	Rs.	R (E 100, SEE) Institution above in	Rs.
Bank	45,000	By Liquidator's Remuneration	24,900
Sundry Debtors	1,20,000	(Note 3)	
Stock	89,000	Liquidation Expenses	16,350
Plant & Machinery	3,00,000	Preferential Creditors	22,500
Patents	46,000	Debenture-holders (having	
Surplus from Land and		a floating charge):	196
Buildings (Note 1)	1,05,000	5% Debentures 1,50,000	
		Interest (Note2) 11,250	1,61,250
		Unsecured Creditors	1,20,000
		Pref. Shareholders:	
	en faturation s	Pref. Sh. Capital 3,00,000	ection.
NA ACTION OF THE PROPERTY OF T		Arrear Dividend 36,000	3,36,000
		Eq. Shareholders (Note 6):	963
		Rs.75 paid (1,500 × 15.25)	22,875
		Rs.60 paid (4,500 × 0.25)	1,125
	7,05,000		7.05,000

Working Notes

1. Surplus from Land & Buildings	2. Interest on Debentures

	Rs.		Rs.
Amount realised	1,80,000	As per last Balance Sheet	7,500
Less: Mortgage Loan	75,000	Add: Interest from 1.4.05 to 30.9.05, i.e.,	
	1,05,000	for 6 months @ 5%	
ative street		on Rs.1,50,000	3,750
ASIA STREET			11,250

3. Liquidator's Remuneration

Realisation of assets except Cash at Bank	7 25 000
(1,20,000 + 89,000 + 3,00,000 + 46,000 + 1,80,000)	7,35,000
3% on assets realised (7,35,000 × 3%)	22,050
2% on payment to Unsecured Creditors including	
Preferential Creditors [(2,17,500 - 75,000) × 2%]	2,850
	24,900

4. Amount Available for Equity Shareholders

		Rs.
Amount available for payments :		7,05,000
Less: Payments for:		
Liquidator's remuneration	24,900	
Liquidation expenses	16,350	
Preferential Creditors	22,500	
Debenture-holders including interest	1,61,250	
Unsecured Creditors	1,20,000	3,45,000
Amount available for Shareholders	-T-#	3,60,000
Less: Amount to be returned to Pref. Shareholder	's :	
Paid up Pref. Capital	3,00,000	
Arrear dividend for 2 years	36,000	3,36,000
Amount Available		24,000

5. Deficiency for Equity Shareholders

	Rs.
Paid up Equity Share Capital (1,12,500 + 2,70,000)	3,82,500
Less : Amount available (Note 4)	24,000
Total Deficiency	3,58,500
% Deficiency = (Total deficiency × 100)/(Nominal value of shares)	
= (Rs.3,58,500 × 100)/6,00,000 = 59.75%	

6. Payment to Equity Shareholders

			1	11
Net amount returnable per share :		a. 0.04.19	Rs.	Rs.
Paid up value per share			75.00	60.00
Less: Deficiency per share @ 59.75%	6 of			
nominal value (Note 5)			59.75	59.75
			15.25	0.25

Illustration 6 :

Iron Ltd. went into voluntary liquidation on December 31, 2005. On that day the details relating to the liquidation are as follows:

Share Capital:	Rs.
4,000 6% Preference Shares of Rs.100 each fully paid	4,00,000
Class 'A' 4,000 Equity Shares of Rs.100 each, Rs.75 paid	3,00,000
Class 'B' 3,200 Equity Shares of Rs.100 each, Rs.60 paid	1,92,000
Class 'C' 2,800 Equity Shares of Rs.100 each, Rs.50 paid	1,40,000

Assets excluding Machinery realised Rs.6,79,000. Liquidation expenses (including liquidator's remuneration Rs.21,000) amount to Rs.30,000. Iron Ltd. has taken a loan of Rs.1,00,000 from State Bank of India against the mortgage of Machinery which realised Rs.1,61,000. In the books of the company salaries of 8 Clerks for 4 months @ Rs.300 per month and salaries of 8 Peons for 3 months @ Rs.150 per month, are due for payment. In addition to this, the books of the company show the Creditors worth Rs.1,74 800.

Prepare Liquidator's Statement of Account.

Solution:

Liquidator's Statement of Account for period ended 31.12.2003

Receipts	Amount	Payments	Amount
	Rs.	and wedge the state of the state of	Rs.
To Assets realised	6,79,000	By Liquidator's remuneration	21,000
Surplus from Machinery	61,000	Liquidation expenses	9,000
(1,61,000 - 1,00,000)		Preferential Creditors	11,600
Eq. Shareholders (Note):		(Note 1)	
Proceeds of Call	or chostness	Unsecured Creditors	1,76,400
@ Re.1 per share on		$(1,74,800 + 200 \times 8)$	
Class 'C' shares	spirity Strip	Pref. Shareholders	4,00,000
(Re.1 × 2,800)	2,800	Eq. Shareholders (Note 4):	
	1 82 3	4,000 on Class 'A' shares	96,000
	5.00 32	(Rs.24 × 4,000)	88
		3,200 on Class 'B' shares	28,800
William State	1811	(Rs.9 × 3,200)	
THE PERSON NAMED IN	7,42,800	Salahyasan Suyan Salaha	7,42,800

Working Notes:

			SALES OF THE PARTY
4	Payment to	Dunfanantial	Cenditoen
	Payment to	Preferential	Ciculiois

Salary of Clerks :	For 8 Clerks for 4 months at Rs.1,200 each,	Rs.
	limited to Rs.1,000 each (Rs.1,000 × 8)	8,000
Salary of Peons :	For 8 Peons for 3 months at Rs.450	3,600
	(Rs.450 × 8)	11,600

2. Amount Available for Equity Shareholders

n tota, – lang 0 set them Otsest in somethy se		Rs.
Assets realised (6,79,000 + 1,61,000)		8,40,000
Less: Payments for: A de la company of the land		
Liquidator's remuncration	21,000	
Liquidation expenses	9,000	
Secured Creditors	1,00,000	
Preferential Creditors	11,600	
Unsecured Creditors		
[1,74,800 + 200 × 8 (Salary of Clerks)]	1,76,400	3,18,000
Amount available for Shareholders	V 5	5,22,000
Less : Preference Share Capital		4,00,000
Amount Available		1,22,000

3. Deficiency for Equity Shareholders

	Paid up Equity Capital	6,32,000
4	Less : Amount available (Note 2)	1,22,000
	Total deficiency	5,10,000
40	% Deficiency = (Total deficiency × 100)/Nominal value of = (Rs.5,10,000 × 100)/10,00,000 = 51%	shares

4. Amount Receivable or Payable to Equity Shareholders

CONTRACTOR OF STREET	'A' shares Rs.	'B' shares Rs.	'C' shares Rs.
Paid up value per share	75.00	60.00	50.00
Less: 51% deficiency of nomina value per shares	d <u>51.00</u>	<u>51.00</u>	51.00
Per share net payable/receivable	(-) 24.00	9.00	(-) 1.00

5.11 Summary

The legal process to bring an end of the corporate life of any company is known as liquidation of company. The Statement of Affairs and Deficiency Account are prepared by the company while the Liquidator's Statement of Account is prepared by the liquidator. For accounting purposes, the preparation of these statements, requires knowledge over the legal provisions regarding liquidation of company in particular and accounting knowledge in general. Actually, they are pro-forma based accounting which must comply with the legal requirements.

5.12 Exercises

Problem 1 :

The following particulars were extracted from the books Alpha Limited as on March 31, 2005 on which date a winding up order was made:

Equity Share Capital :	Rs.
4,000 Shares of Rs.100 each, Rs.50 called up	2,00,000
Calls in arrear (estimated to produce Rs.10,000)	12,000
6% Preference Share Capital:	
4,000 Shares of Rs.100 each, fully called up	4,00,000
5% Debentures secured by first floating charge	3,00,000
Bank Overdraft secured by second floating charge	30,000
Fully Secured Creditors (secured on investments)	60,000
Partly Secured Creditors (secured on investments)	40,000
Investments with fully secured creditors (estimated	
to produce Rs.70,000)	80,000
Investments with partly secured creditors (estimated	
to produce Rs.20,000)	50,000
Rate & Taxes	2,000
Wages & Salaries	4,000
Bills Payables	1,80,000
Sundry Creditors	1,60,000
Bills Receivable in hand	24,000
Sundry Debtors (estimated to produce Rs.33,000)	52,000
	700 M 10 M 10

Land & Building (estimated to produce Rs.2,00,000)	2,80,000
Stock-in-trade (estimated to produce Rs.80,000)	1,20,000
Machinery (estimated to produce Rs.4,000)	,6,000
Cash in hand	400
Bills Discounted Rs.60,000, likely to be dishonoured	20,000
Contingent Liability Rs.20,000, likely to be paid	14,000

You are asked to prepare (i) Statement of Affairs and (ii) Deficiency Account assuming that no journal entry was made for outstanding rent Rs.5,000.

Hints: Trial Balance is not given. It is necessary to prepare the Trial Balance. The difference between and credit should be considered as either accumulated loss or profit which will be taken to Deficiency Account.

Answer: Total deficiency Rs.9,71,600.

Problem 2:

The Surprise Ltd. went into voluntary liquidation on January 1, 2006. The liquidator is entitled to a commission of 3% on realisation of all assets and 2% on distribution to shareholders. The following was the position of the company as on December 31, 2005:

	Rs.
Cash on realisation of assets	5,00,000
Expenses on liquidation	9,000
Unsecured Creditors (including salaries and wages for	
one month prior to liquidation, Rs.6,000)	68,000
15,000 6% Preference Shares of Rs.10 each (dividend	
paid up to December 31, 2002)	1,50,000
1,000 Equity Shares of Rs.100 each, Rs.90 per called	
and paid up	90,000

Under the Articles of Association of the company the Preference Shareholders have the right to receive third of the surplus remaining after repaying Equity Share Capital.

Answer: Liquidator's remuneration Rs.23,000; Payment to shareholders: Preference ShareholdersRs.2,09,333; Equity Shareholders Rs.1,90,667.

5.13 Questions

- What do you mean by liquidation of companies? What are the effects of liquidation?
 State different types of liquidation.
- Q.2 What is Statement of Affairs? How is such statement prepared? Why is it prepared?

- Q.3 What is Deficiency Account? What are the objects of its preparation?
- Q.4 What is meant by Preferential Creditors? What are the items that are to be included in preferential creditors?
- Q.5 What do you mean by Liquidator's Final Statement of Account? Can it be said Cash Book? What are the orders of payments that are shown in this statement?
- Q.6 Mention the correct answer:
 - 1. A contributory is (a) a creditor; (b) a shareholder; (c) a debenture-holder.
 - The wages of 3 workers for a period of 5 months prior to the date of liquidation was in arrear. If the wages of each worker is Rs.1,400 per month the amount to be included in preferential creditors will be (a) Rs.21,000; (b) Rs.16,800; (c) Rs.3,000.
 - 3. Mr. X is the liquidator of company. He is entitled to a commission @ 2% on assets realised and 3% on the amount distributed to shareholders. The assets realised Rs.2,00,000 including cash balance of Rs.6,000. The amount available for distribution to shareholders before his commission was Rs.96,580. The commission of Mr. X will be (a) Rs.6,280; (b) Rs.6,200; (c) Rs.6,580.

Answers: 1(b), 2(c), 3(c).

5.14 Suggested Readings

- 1. Chakraborty, H: Advanced Accountancy, Oxford University Press.
- Shukla, M.C; Grewal, T. S. & Gupta, S. C: Advanced Accounts, S. Chand & Co. (Pvt.) Ltd.
- 3. Gupta, R. L. & Radhaswamy, M: Advanced Accounts, Sultan Chand & Sons.

Unit 6 Consolidated Accounts Structure 6.0 Objective 6.1 Introduction 6.2 Legal Definition 6.3 Legal Requirements for Presentation of Information Requirements of AS-21 on Consolidated Financial Statement 6.4 Consolidated Balance Sheet 6.5 6.6 **Principles of Consolidation** 6.6.1 Capital and Revenue Profits 6.6.2 Elimination of Investment in Subsidiary Company Cost of Control/Goodwill or Capital Reserve 6.6.3 6.6.4 **Minority Interest** 6.6.5 Treatment of Dividend Revaluation of Fixed Assets 6.6.6 6.6.7 Under or over-depreciation 6.6.8 Issue of Bonus Shares 6.6.9 Preference Shares of Subsidiary Company 6.6.10 Debentures of Subsidiary Company 6.6.11 Unrealised Inter-Company Profits 6.6.12 Inter-Company Transactions 6.6.13 Contingent Liabilities 6.7 Consolidated Profit and Loss Account Group Consisting of more than one Subsidiary-chain-holding 6.8

- 6.9 Summary
- 6.10 Exercises
- 6.11 Questions
- 6.12 Suggested Readings

6.0 Objective

By the time you have gone through this unit you would be able to:

- know the general and legal definitions of holding company;
- grasp the legal requirements of consolidated financial statements in India;
- grasp the disclosure requirements of the consolidated financial statements as per AS 21; and
- know the principles of consolidation of balance sheets and profit & loss accounts of holding company and its subsidiaries.

6.1 Introduction

A holding company is one, which controls one or more other companies and enjoys control over them by means of holding majority of its shares or by having powers to appoint directly or indirectly the majority or whole of the Board of Directors of those companies. Holding company is also called parent company. A company controlled by a holding company is known as subsidiary company. Legally a holding company and its subsidiaries are distinct and separate entities. However, in substance both the holding and subsidiary companies work as group. Although preparation of consolidated financial statements is not compulsory in India under the Companies Act 1956, but users of holding company accounts need financial information of subsidiaries in order to evaluate the overall performance and financial position of the holding company. Thus, with a view to satisfying the need of the users, it is desirable to prepare such consolidated financial statements for the group of companies.

In the following sections, legal definition of holding company and requirements in respect of consolidated financial statements under the Companies Act, 1956 and requirements under AS-21 as prescribed by the ICAI are discussed.

6.2 Legal Definition

There is no legal definition of holding company in the Companies Act, 1956. Thus, the definition of holding company could be understood from the legal definition of subsidiary

company. But, according to Section 4(1) of the Act, a company shall be deemed to be a subsidiary of another if and only if—

- (a) that other controls the composition of its Board of Directors; or
- (b) that other
 - (i) where the first 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 respects as the holders of equity shares,
 exercises or controls more than half of the total voting power of such
 company;
 - (ii) where the first mentioned company is any other company, holds more than half in value of its equity share capital; or
- (c) the first mentioned company is a subsidiary of any company which is that other's subsidiary.

A company shall be deemed to be the holding company of another, if and only if, that other is its subsidiary.

Illustration 1:

Company B is a subsidiary of Company A and Company C is a subsidiary of Company B, then Company C is a subsidiary of Company A. If Company D is a subsidiary of Company C, then Company D will also be subsidiary of Company B and consequently also of Company A.

6.3 Legal Requirements for Presentation of Information

Under Section 212, every holding company is required to attach to its balance sheet the following documents in respect of its subsidiaries:

- (a) a copy of the balance sheet of the subsidiary;
- (b) a copy of its profit and loss account;
- (c) a copy of the report of its Board of Directors;
- (d) a copy of the report of its auditors;
- (e) a statement of the holding company's interest in the subsidiary as specified in sub-section (3) of Section 212;
- (f) the statement referred to in sub-section (5) of Section 212, if any; and
- (g) the statement referred to in sub-section (6) of Section 212, if any.

The interval between the close of the financial year of the subsidiary company and that of the holding company shall not be more than 6 months for the purpose of Section 212. The Central Government has the power to issue necessary instructions for this purpose in case when the interval between the close of the financial year of the subsidiary company and that of the holding company is longer than 6 months [Section 213(2)].

The statement referred to in (e) above in sub-section (3) of Section 212 shall contain the information noted below:

- (a) the extent of the holding company's interest in the subsidiary as at the end
 of the financial year of the subsidiary company;
- (b) the net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiary's after deducting its losses—
- (i) for the financial year or years of the subsidiary covered by the balance sheet and profit and loss account;
 - (ii) for the previous financial years of the subsidiary since it became the holding company's subsidiary;
 - (c) the net aggregate amount of the profits of the subsidiary after deducting its losses:
 - (i) for the financial year under report; and
 - (ii) for the previous financial years of the subsidiary company since it became the holding company's subsidiary.

So far as those profits or losses have been dealt with in the holding company's accounts.

Profits and losses stated in paragraphs (b) and (c) are only such amounts that may be treated by the holding company as revenue profits or losses. From the point of view of the holding company, a clear distinction must be made as to the allocation of profits or losses between revenue profit (or loss) and capital profit (or loss) of the subsidiary. In the absence of information, profits or losses of the subsidiary of a year may be treated as accruing from day to day [sub-section (4) of Section 212].

According to sub-section (5) of Section 212, where the financial years of the holding company and subsidiary company do not coincide, a statement containing the following particulars shall be attached to the every balance sheet of the holding company:

(a) the change and the extent thereof, in the holding company's interest in the subsidiary between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year; and

- (b) details of any material changes which occurred between the end of the financial year or of the last of the financial years of the subsidiary and the end of the holding company's financial year in respect of:
- (i) the subsidiary's fixed assets;
 (ii) its investments;
 (iii) the moneys lent by it;
 and (iv) the moneys borrowed by it for any purpose other than that of meeting current liabilities.

In view of the amendment in the Income-tax Act, 1961, the financial year of any company must begin on 1st April and end on 31st March of the subsequent year. However, there is no scope of the difference as to the close of the financial year between the subsidiary company and holding company. Thus, sub-section (5) of Section 212 is not relevant in the context of the amendment in the Income-tax Act.

6.4 Requirements of AS-21 on Consolidated Financial Statements

In India, preparation of Consolidated Financial Statement (CFS) is not compulsory under the Companies Act, 1956. The Act also stipulates that a holding company should provide in respect of each of its subsidiaries a few copy of documents and statements that are to attached to its balance sheet. But, 'AS-21: Consolidated Financial Statement', as prescribed by the ICAI requires mandatory preparation of CFSs for the parent corporate entities with effect from the accounting year commencing on or after 1.4.2001. Such CFSs should consolidate all subsidiaries, domestic and foreign, other than a subsidiary when:

- (a) control is extended to be temporary because the subsidiary is acquired and held exclusively with a view to its subsequent disposal in near future; or
- (b) it operates under severe long-term restrictions which significantly impair its ability to transfer funds to the parent.

The Standard also requires that the financial statement used in consolidation should be drawn up to the same reporting date. If it is not possible for one or more subsidiaries to draw up the financial statement to such date, adjustments should be made for the effect of significant transactions or other events that occur between the dates on which financial statement of one or more subsidiaries are drawn and the date of the parent company's financial statement. Under no case, the difference between reporting dates should be more than 6 months.

6.5 Consolidated Balance Sheet

A consolidated balance sheet is the balance sheet of the holding company and its subsidiary company or companies, which is prepared in order to show the assets and liabilities of the group in a consolidated form. The object of preparing a consolidated balance sheet is to provide the shareholders of the holding company with a comprehensive picture in respect of the state of affairs of the group.

6.6 Principles of Consolidation

The basic principle of consolidation is the aggregation of the assets and liabilities of the subsidiary company or companies with those of holding company. Preparation of consolidated balance sheet requires allocation of profits and reserves and surplus of the subsidiary company into capital and revenue profits. It requires elimination of different items such as, inter-company investments and share capital of subsidiary company, inter-company balances, unrealised inter-company profits on stocks and other assets held at balance sheet date, etc. Let us have a brief discussion on different items in the paragraphs that follow.

6.6.1 Capital and Revenue Profits

The date of acquisition of shares in the subsidiary company by the holding company is the primary factor in determining capital and revenue profits. Profit earned by the subsidiary company up to the date of acquisition of shares by the holding company is known as capital profit or pre-acquisition profit. In other words, the profit including reserves would have been standing in the balance sheet of the subsidiary company at the time of acquisition of shares is regarded as capital profit. Also, profit or loss on revaluation of fixed assets of the subsidiary company is taken as capital profit or capital loss respectively. Capital profit to the extent of the share of holding company is to be adjusted against cost of control or goodwill whereas the share of outside shareholders in the same should be adjusted against minority interest. Capital profit includes the following:

- (a) Capital reserve and securities premium whether they arose in pre-acquisition or post-acquisition period;
- (b) Credit balance in the general reserve account or any other reserve account;
- (c) Credit balance in the profit and loss account;

- (d) Bonus shares if issued out of either pre-acquisition profit or post-acquisition profit and if not recorded in the books of subsidiary company;
- (e) Any dividend paid out of pre-acquisition profits;
- (f) Profit on revaluation of fixed assets; and
- (g) Increase in the value of stock at the time acquisition of shares.

Profit earned by the subsidiary company after acquisition of shares by the holding company is termed as revenue profit or post-acquisition profit or current profit. In other words, profits including reserves earned subsequent to the date of purchase of shares are taken as revenue profits. Revenue profits to the extent of the share of holding company may be transferred either to the profit and loss account only or, to the general reserve account and profit & loss account of the holding company on the basis of proportionate share in those accounts of subsidiary company by the holding company. But, the share of the outside shareholders in the revenue profits may be transferred only to the 'minority interest account' and 'proposed dividend for minority account' on the basis of proportionate claim in those accounts of the minority shareholders. It includes the following:

- (a) Profits including transfer to reserves and dividend paid or proposed, if any, out of profits earned in the post-acquisition period by the subsidiary company;
 and
- (b) Over-depreciation on fixed assets on account of revaluation will increase revenue profit while under-depreciation will reduce the same.

6.6.2 Elimination of Investment in Subsidiary Company

The shares of the subsidiary company which are acquired by the holding company is shown in the asset side of the balance sheet of the holding company under the head "Investment' and the same is shown in the liability side of the balance sheet of the subsidiary company under the head 'Share Capital'.

Where the holding company acquires all the equity shares of the subsidiary company at par, in that case, for the purpose of consolidation, the investment account of the holding company and share capital account of the subsidiary company should be eliminated. This is the essence of consolidation. Other assets and liabilities of the subsidiary company will be aggregated with those of the holding company. The example given below will make the principle clear.

Illustration 2:

Balance Sheets of X Ltd. and Y Ltd. as at March 31, 2005

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Equity share capital (Rs. 10 each) Creditors	Rs.	Rs.	Sundry Assets	Rs. 2,50,000	Rs. 1,60,000
	2,40,000 1,10,000	1,00,000 60,000	Investment in 10,000 shares of Y Ltd.	1,00,000	Nil
	3,50,000	1,60,000		3,50,000	1,60,000

Prepare a Consolidated Balance Sheet as at March 31, 2005.

Solution

The elimination of both the investment of X Ltd. and the share capital of Y Ltd. can be shown by the following journal entry:

	Chamber of	Dr.	Cr.
Southern Committee Committee State	201 201 1	Rs.	Rs.
Share Capital Account (Y Ltd.)	Dr.	1,00,000	15.00
To Investment Account (X Ltd.)			1,00,000
[Investment in 10,000 share of Y Ltd. by X Ltd.			0)
cancelled against Share Capital of Y Ltd.]		al ou pay the	barth dark

Consolidated Balance Sheet of X Ltd. and its subsidiary, Y Ltd. as at March 31, 2005

Liabilities	Amount	Assets	Amount
	Rs.	vera en la vera de la	Rs.
Equity Share Capital (Rs. 10 each) Creditors (1,10,000 + 60,000)	2,40,000 1,70,000		4,10,000
	4,10,000		4,10,000

6.6.3 Cost of Control/Goodwill or Capital Reserve

There may be a situation where the holding company acquires all the equity shares in the subsidiary company at a premium or at a discount and, at the same time, the subsidiary company may have some accumulated profit or loss on the date of acquisition of shares. In that situation, the excess price paid by the holding company over the equity acquired or net assets acquired is described as goodwill to be recognised as an asset. But, when

the price paid is lower than the equity acquired, the difference should be treated as capital reserve to be shown in the consolidated balance sheet under the head "Reserves and Surplus". The following example will make the principle clear.

Illustration 3:

Balance Sheets of P Ltd. and Q Ltd. as at March 31, 2005

Liabilities	P Ltd.	Q Ltd.	Assets	P Ltd.	Q Ltd.
Equiry Share Capital	Rs.	Rs.	Marine I. Weinsen	Rs.	Rs.
(Rs. 100 each)	2,00,000	1,00,000	Sundry Assets	1,66,000	1,62,000
General Reserve Profit & Loss A/c	40,000 20,000	12,000 10,000	Investment (1,000 shares in Q Ltd.)	1,74,000	Nil
Creditors	80,000	40,000	Pare Small and		
A Park	3,40,000	1,62,000		3,40,000	1,62,000

P Ltd. acquired shares in Q Ltd. on April 1, 2004. Prepare a Consolidated Balance Sheet.

Solution

To find out the amount of either goodwill or capital reserve arising on purchase of shares in Q Ltd., a journal entry may be passed as below:

		Dr.	Cr.
pspoods.		Rs.	Rs.
Equity Share Capital Account (Q Ltd.)	Dr.	1,00,000	
General Reserve Account (Q Ltd.)	Dr.	12,000	
Profit & Loss Account (Q Ltd.)	Dr.	10,000	
Goodwill Account (Balancing figure)	Dr.	52,000	
To Investment Account (P Ltd.)			1,74,000
[Investment of P Ltd. cancelled against Equity	Share	SILVERY IN	
Capital and Reserves & Surplus and the excess over equity acquired debited to Goodwill Accou			

Note: Where the payment for purchase of shares is lower than the equity or net assets acquired, the difference will be treated as Capital Reserve.

Consolidated Balance Sheet of P Ltd. and its subsidiary, Q Ltd. as at March 31, 2005

Liabilities	Amount	Assets	Amount
Equity Share Capital	Rs.	Goodwill	Rs. 52,000
(Rs. 100 each)	2,00,000	Sundry Assets	
General Reserve	40,000	(1,66,000 + 1,62,000)	3,28,000
Profit & Loss A/c	20,000		North Street
Creditors (80,000 + 40,000)	1,20,000		
	3,80,000		3,80,000

6.6.4 Minority Interest

The collective interest of the outside shareholders in the subsidiary company is known as *minority interest*. Minority interest is treated as current liability and is shown as a separate item in the consolidated balance sheet. The minority interest consists of the paid up value of shares held by the outsiders plus their proportionate share in capital and revenue profit minus their proportionate share of capital and revenue loss. The following example will make the principle clear in respect of minority interest along with cost of control, i.e., goodwill or capital reserve.

Illustration 4:

Balance Sheets of M Ltd. and N Ltd. as at March 31, 2005

Liabilities	M Ltd.	N Ltd.	Assets	M Ltd.	N Ltd.
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital			Sundry Assets	1,90,000	1,70,000
(Rs. 100 each)	1,50,000	1,00,000	Investments (in 800		
General Reserve	40,000	12,000	shares of N Ltd.)	90,000	Nil
Profit & Loss A/c	30,000	28,000		4:	
Creditors	60,000	30,000	10 to 20 to 11 WESSEL BELL		
	2,80,000	1,70,000		2,80,000	1,70,000

M Ltd. purchased shares in N Ltd. on July 1, 2004. On April 1, 2004 N Ltd. had Rs.10,000 in General Reserve and Rs.8,000 in Profit & Loss Account (Credit balance). Profits earned by N Ltd. accrue evenly throughout the year. No dividend was paid during the year ended March 31, 2005.

Prepared a Consolidated Balance Sheet.

Solution

In solving the problem, statement form of presentation is followed.

(1) Share of control in N Ltd.

M Ltd. =
$$(800)/(1,000) = 4/5$$
 or 80%

Outsiders = (200)/(1,000) = 1/5 or 20%

(2) Analysis of Profits of N Ltd.

000082	10.00.1	Capital Profit	Revenue Gen. Res.	Revenue P & L
		Rs.	Rs.	Rs.
General Reserve on 1.7.2004:	5.78	Brink	(diam	di tala
Balance in 1.4.2004	10,000		chia ova use	La syme
Add: Increase for first 3 months	2 180 4			
[(12,000 – 10,000) × 3/12]	500	10,500	en self in ne	or a line
Increase in General Reserve for last 9 months	3			and the same
(12,000 – 10,500)	2 Wide II		1,500	al plant
Profit & Loss on 1.7.2004	- 100		Of Olines III	F REALS
Balance on 1.4.2004	8,000	September 1	MUSIC NIL	E SUPPLIES
Add: Increase for first 3 months			1000	and a start from the
[(28,000 - 8,000 × 3/12)]	5,000	13,000		
Increase in Profit & Loss for last 9 months		WE KET	1	
(28,000 – 13,000)				15,000
and - (-a ore of - so at - time +		23,500	1,500	15,000
Less : Share of minority (20%)		4,700	300	3,000
Share of M Ltd.		18,800	1,200	12,000

(3) Cost of Control/Goodwill or Capital Reserve

	Amount	Amount
	Rs.	Rs.
Cost of Investment in Shares of N Ltd.		90,000
Less: Paid up value of 800 shares of Rs.100 each	80,000	CONTOLLIN
Share of Capital Profit	18,800	98,800
Capital Reserve		8,800

(4) Minority Interest

i huma nue la agra maka not, collantiro, blouroa sati de estano soci	Amount	Amount
	Rs.	Rs.
Paid up value of 200 shares of Rs. 100 each held by	Landikino	
outsiders of the stanger of the stan	Bab 105200	20,000
Add: Share of Capital Profit	Herita Marin	4,700
Share of Revenue Profit :	Bed Hills	
General Reserve	300	PART OF THE
Profit & Loss	3,000	3,300
		28,000

(5) Group Reserves and Surplus

ne control and un anithmeters, in basical or least a subject to the	Gen. Res.	P & L
	Rs.	Rs.
Balance on 31.3.2005 (M Ltd.)	40,000	30,000
Add: Share of Revenue Profit	1,200	12,000
	41,200	42,000

Consolidated Balance Sheet of M Ltd. and its subsidiary, N Ltd. as at March 31, 2005

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Equity Share Capital		Sundry Assets	3,60,000
(Rs. 100 cach)	15,00,000	(1,90,000 + 1,70,000)	
Capital Reserve	8,800		
General Reserve	41,200	2002 77 区划市、首任、安排省层。	
Profit & Loss A/c	42,000		
Minority Interest	28,000	party are taken to be been settle	Susa mal
Creditors (60,000 + 30,000)	90,000	on and property and the property of the con-	i, ukoway
	3,60,000	ten besomber and though	3,60,000

6.6.5 Treatment of Dividend

Dividends received or receivable by the holding company from its subsidiary are of three types. They are pre-acquisition dividend, interim dividend and proposed dividend. The treatment of dividend received must vary in the books of the holding company

depending on the nature of profits utilised by the subsidiary company for its payment. The accounting treatment in the books of the holding company for each type of dividend is explained as follows:

I. Pre-acquisition Dividend—Dividend received out of capital profits must be credited to the 'Investment Account' since the cash received is against the price of shares paid at the time of the acquisition. Thus, journal entry for receiving such dividend is to debit the Cash Account and to credit the Investment Account. But, when it is wrongly credited to the Profit and Loss Account, a rectifying journal entry is required. The entry for rectifying the mistake will to debit the Profit and Loss Account and to credit the Investment Account of the holding company.

II. Interim Dividend—Dividend paid by a company due to sufficiency of estimated profit earned by it for an interim period usually for first six months of the accounting year is known as interim dividend This dividend may be treated in accounting in the following lines:

- (a) No adjustment is required in the books of holding company when interim dividend is paid out of post-acquisition profit and recorded as credit to the Profit and Loss Account for its share in the same.
- (b) When interim dividend is paid out of pre-acquisition profit, the accounting treatment will be the same as mentioned in sub-section (I) of Section 6.6.5.
- (c) When interim dividend is paid partly out of pre-acquisition profit and partly out of post-acquisition profit, the accounting will be:
 - (i) For portion of dividend paid out of pre-acquisition profit—same as mentioned in sub-section (I) of Section 6.6.5.
 - (ii) For portion of dividend paid out of post-acquisition profit—same as mentioned in sub-section [II(a)] of Section 6.6.5.

III. Post-acquisition Dividend—No adjustment is required in the books of holding company when dividend is paid out of post-acquisition profit by the subsidiary company provided it is recorded at the time of receipt of dividend.

IV. Proposed Dividend—Proposed dividend of the subsidiary company may be given in the problem either in the balance sheet or in the adjustment. The accounting treatment may be made in the following lines:

(a) When it is given in the balance sheet—(i) add the share of the holding company to its Profit and Loss Account and the share of minority is to be kept in a separate account styled as 'Proposed Dividend for Minority Account' under the head 'Current Liabilities and Provisions' in the consolidated balance sheet, or, (ii) it may be added to the post-acquisition profit whose accounting treatment is already known to you and deduct the share of minority from Minority Interest Account with a view to showing it separately in the Proposed Dividend for Minority Account.

(b) When it is given in the adjustment—(i) no accounting treatment is required for it except the subtraction of the share of minority in the amount of proposed dividend from Minority Interest Account in order to show it in the Proposed Dividend for Minority Account, or, (ii) it may be disallowed altogether, in that case, Minority Interest Account will represent usual claims plus the share of proposed dividend of the minority.

6.6.6 Revaluation of Fixed Assets

Holding company may revalue the fixed assets of its subsidiary with a view to determining the price to be paid for acquiring controlling interest. The profit or loss on revaluation of assets should be taken as either capital profit or capital loss.

6.6.7 Under or Over-depreciation

Depreciation on revalued amount of fixed assets should be considered. Additional depreciation should be provided on the increased value of fixed assets while excess depreciation on decreased value of fixed assets should be added back. Both the additional and excess depreciation, i.e., under-depreciation and over-depreciation should be adjusted against post-acquisition profit.

6.6.8 Issue of Bonus Shares

Subsidiary company may issue bonus shares utilising either pre-acquisition profit or post-acquisition profit—the amount involved in issuing bonus shares is always a part of capital profit. The issue of bonus shares may be dealt with in the following lines:

- I. Where the issue of bonus shares is recorded in the books of subsidiary company—no adjustment is required to be made in the preparation of consolidated balance sheet.
- II. Where such issue of shares is not recorded in the books of subsidiary company—the amount of total bonus issue either may be shown as a separate item in the capital profit or it may be left untouched with a note only against the item or items of profit from which it would be utilised for that purpose.

6.6.9 Preference Shares of Subsidiary Company

The treatment of preference shares may be made in the following lines:

I. When all the preference shares are held only by outsiders—The entire amount of paid up preference share capital should be included in Minority Interest Account along with arrear dividend. Arrear preference dividend should be deducted first from existing profits before making allocation of it between holding company and minority.

II. When preference shares are held partly by the holding company and partly by the outsiders—The accounting treatment will be the same as that of equity shares except the arrear preference dividend which will be treated as in sub-section (I) of Section 6.6.9.

6.6.10 Debentures of Subsidiary Company

Where some debentures of subsidiary company are held by the holding company, cancellation of such debentures to the extent of holding company's share should be made against both the total debentures issued by the subsidiary company and investment in debentures of subsidiary company. The difference between the cost price and the paid up value should be adjusted to cost of control/goodwill or capital reserve.

6.6.11 Unrealised Inter-company Profits

Where one company in the group holds unsold stock or fixed asset purchased from another as at the date of consolidated balance sheet, an adjustment is required to eliminate unrealised inter-company profit on stock or fixed asset. The argument for creating provision for unsold stock or provision for fixed asset held is that the profit is not truly realised because such stock or fixed asset is not sold out to the outside buyers. Full amount of unrealised profit should be provided as provision as per AS-2.

6.6.12 Inter-company Transactions

There may be number of inter-company transactions between the holding company and subsidiary company. These transactions may relate to any one or more of the following:

- (a) Sale of goods on credit by the holding company to the subsidiary company or vice- versa. These transactions must create debtors and creditors in the books of company concerned.
- (b) Granting of loans and advances by the holding company to the subsidiary company or vice-versa.
- (c) Drawing of bill of exchange by the holding company on subsidiary company or vice-versa.

As a result of the abovementioned inter-company transactions, some accounts are shown as assets in the books of holding company and the same accounts are shown as liabilities in the books of subsidiary company. In preparing consolidated balance sheet, inter-company assets and liabilities should be eliminated with the existence of common minimum amounts of either company.

6.6.13 Contingent Liabilities

Contingent liabilities relating to external parties only on account of bills discounted, claim for pending suit either against holding company or subsidiary company, unpaid calls on investments, etc. should be shown as a note in preparing consolidated balance sheet.

Illustration 5:

Following are the Balance Sheets of H Ltd. and S Ltd. as at March 31, 2005;

Liabilities	H Ltd.	S Ltd.	Assets	H Ltd.	S Ltd.
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital	100	230	Sundry Fixed Assets	3,40,000	2,60,000
(Rs. 100 each)	4,00,000	2,00,000	Stock	1,60,000	70,000
General Reserve	1,50,000	60,000	Sundry Debtors	1,10,000	80,000
Profit & Loss A/c	1,40,000	1,20,000	Investments	1,70,000	9=
Sundry Creditors	1,00,000	40,000	Bank	20,000	15,000
Bills Payable	10,000	5,000			
	8,00,000	4,25,000		8,00,000	4,25,000

You are given following additional information:

- (a) H Ltd. acquired 1,200 shares in S Ltd. on July 1, 2004.
- (b) On April 1, 2004 S Ltd. had Rs.36,000 in General Reserve and Rs.48,000 in Profit & Loss A/c (Credit balance).
- (c) On July 16, 2004 H Ltd. received dividend for last financial year amounting to Rs.12,000 from S Ltd. and credited the same to its Profit & Loss A/c.
- (d) S Ltd. owed H Ltd. Rs.24,000 for purchase of goods. Half of goods lying unsold on March 31, 2005. H Ltd. made a profit of 20% on sales.
- (e) During 2004-05 S Ltd. had purchased a fixed asset from H Ltd. for Rs.20,000 which had yielded a profit on selling price of 30% to that company. A depreciation of 20% on the asset had been charged in the accounts.

Prepare a Consolidated Balance Sheet as at March 31, 2005.

Solution

Consolidated Balance Sheet of H Ltd. and its subsidiary, S Ltd. as at March 31, 2005.

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital :		Fixed Assets	en cran
Authorised	in situa	Sundry Fixed Assets	Congress of
Equity Shares of	So thin take	(3,40,000 + 2,60,000)	
Rs. 100 each	?	6,00,000	HISTORY .
Issued and Subscribed	90	Less : Provision for	ustration
Equity Share Capital (Rs. 100)	4,00,000	unrealised profit 6,000	wolfe I
Reserves and Surplus		5,94,000	dall .
Capital Reserve	17,800	Add: Over-depreciation 1,200	
Contra	Et Zainuz		5,95,200
General Reserve	1,60,800	Investments	Ni
Profit & Loss A/c	1,65,080	Current Assets, Loans and	M Income
Current Liabilities and	remiseral	Advances	1. 多 仙南
Provisions	Reid	Stock (1,60,000 + 70,000)	A Caling
Sundry Creditors		2,30,000	ille Payab
(1,00,000 + 40,000) 1,40,000		Less : Prov. for stock 2,400	
		arran lessa (Manamovial or es vis	2,27,600
Less: Inter-co. debt24,000	1,16,000	Sundry Debtors	- marile
Bills Payable (10,000 + 5,000)	15,000	(1,10,000 + 80,000) 1,90,000	
Minority Interest	1,49,120	Less: Inter-co. debt 24,000	
			1,66,000
	de Unidos	Bank (20,000 + 15,000)	35,000
DIVERSE STATE	10,23,800	ness and holivate being this it die	10,23,800

Working Notes :

(1) Proportion of holding in S Ltd.:

H Ltd. = (1200)/(2000) = 3/5ths = 60%

Minority = (800)/(2000) = 2/5ths = 40%

(2) Analysis of Profits of S Ltd.

noments manerals		Capital Profit	Revenue Gen. Res.	Revenue P & L
		Rs.	Rs.	Rs.
General Reserve on 1.7.2004 :	w histor		S-Will by St	office and
Balance in 1.4.2004	36,000		1 sh amore	with one
Add: Increase during first 3 months	to sweet		antirova, lic alav qui bil	S S MA
[(60,000 – 36,000) × 3/12]	6,000	42,000		
Increase in General Reserve during last			30,198	ob Intern
9 months (6,000 × 3)			18,000	
Profit & Loss on 1.7.2004		X		
Balance on 1.4.2004	48,000		The to be	
Less: Dividend for 2003-04 (12,000 × 5/3)	20,000		que lo ma	E Eb
	28,000		with the pro-	
Add: Profit for first 3 months			ol families	
$[(1,20,000-28,000)\times 3/12)]$	23,000	51,000	a phos	
Increase in Profit & Loss during last				
9 months (23,000 × 3)	Bila la C	A ESTIVED	DOMETHICS	69,000
Add: Over-depreciation on fixed asset		93,000	18,000	69,000
(20,000 × 30% × 20%)				1,200
		93,000	18,000	70,200
Less: Prov. for fixed asset (20,000 × 30%)	6,000	d northing	us entir the o	
Prov. for stock (24,000 × 1/2 × 20%)	2,400	4/19	2 11111	8,400
200 E 00 E 7	7	93,000	18,000	61,800
Less : Share of minority (40%)		37,200	7,200	24,720
Share of H Ltd.		55,800	10,800	37,080

(3) Cost of Control

	Amount	Amount
	Rs.	Rs.
Cost of 1,200 shares in S Ltd.		1,70,000
Less : Share of pre-acquisition dividend wrongly credited	N. I. and profession	n II Teramon
to the Profit & Loss A/c, now rectified	F. 100 C	12,000
True cost of investment		1,58,000
Less: Paid up value of 1,200 shares of Rs.100 cach	1,20,000	omi hit
Share of capital profit	55,800	1,75,800
Capital Reserve	Medical Real	17,800

(4) Minority Interest

	Amount	Amount
	Rs.	Rs.
Paid up value of 800 shares of Rs.100 each		80,000
Add: Share of capital profit	2 HO- 2002 For Direct	37,200
Share of revenue profit		
General Reserve	7,200	E 16
Profit & Loss	24,720	31,920
		1,49,120

(5) Consolidated Reserves & Surplus

The second secon	Gen. Res.	Amounts P & L
	Rs.	Rs.
Balance of H Ltd. on 31.3.2005	1,50,000	1,40,000
Less : Share of pre-acquisition divided wrongly credited	for fixed as	
to the Profit & loss A/c, now rectified	Children aut	12,000
Livered Lancier Company of the Compa	1,50,000	1,28,000
Add : Share of revenue profit	10,800	37,080
	1,60,800	1,65,080

Illustration 6:

The following are the Balance Sheets of X Ltd. and its subsidiary, Y Ltd. as at March 31, 2005:

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
1600 h = t	Rs.	Rs.	(80) (40)	Rs.	Rs.
Equity Share of			Buildings	1,03,000	40,000
Rs. 10 ech	1,60,000	50,000	Machinery	47,000	27,000
Reserve (1.4.2004)	95,000	12,000	Furniture	5,000	3,000
Profit & Loss A/c	80,000	37,000	Investments	90,000	av. late
Creditors	15,000	16,000	Stock-in-trade	34,000	18,200
Bills Payable	_	10,000	Debtors	38,000	26,000
(issued to X Ltd.)	other	mi-Accord	Bank	33,000	10,800
	3,50,000	1,25,000		3,50,000	1,25,000

X Ltd. purchased 3,000 shares in Y Ltd. on July 1, 2004 at a total cost of Rs.90,000. The Profit & Loss A/c of X Ltd. includes interim dividend @10% from Y Ltd. declared after July 1, 2004. Y Ltd. proposed a final dividend of 12% for the year 2004-05.

The balance in Profit & Loss A/c on April 1, 2004 in the books of Y Ltd. was Rs.17,000. The profit during the year 2004-05 has been earned uniformly throughout the year. Interim was paid for first 6 months of the accounting year out of current year's profit.

Machinery standing in the books of Y Ltd. at Rs.30,000 on the date of purchase was revalued at Rs.25,250. A fire was occurred in the Godown of Y Ltd. on January 14, 2005 destroying goods of the cost of Rs.8,000. The insurance company had paid a claim of Rs.5,000.

Prepare a Consolidated Balance Sheet as at March 31, 2005.

Solution

Consolidated Balance Sheet of X Ltd. and its subsidiary, Y Ltd. as at March 2005.

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital :	W	Fixed Assets	THE WO
Authorised	?	Goodwill	40,800
Issued and Subscribed		Buildings (1,03,000 + 40,000)	1,43,000

Liabilities	Amount	Assets	Amount
train in a Up 17, provide a	Rs.	in about a malation of boots of	Rs.
Equity Shares of Rs. 10 each	1,60,000	Machinery	
Reserves & Surplus	e A	(47,000 + 27,000) 74,000	
Reserve	95,000	Less: Revaluation Loss 4,000	
Profit & Loss A/c	87,980	70,000	
Current Liabilities & Prov.	resuspeld	Add: Over-depreciation 300	70,300
Creditors (15,000 + 16,000)	31,000	Furniture (5,000 + 3,000)	8,000
Bills Payable	10,000	Investments	Nil
Minority Interest	35,720	Current Assets, loans and	
Proposed div. (minority only)	2,400	Advances	
nave more	2008	Stock-in-trade	
e 145 to 160,000		(34,000 + 18,200)	52,200
		Debtors (38,000 + 26,000)	64,000
	CHECK HIS	Bank (33,000 + 10,800)	43,800
	4,22,100	rogi s terrosola on L.C. 4400	4,22,100

Working Notes:

(1) Proportion of holding in Y Ltd.:

(2) Profit and Loss Account (Y Ltd.)

	Amount		Amount
	Rs.	Consolidated Dalance Shoet	Rs.
To Interim dividend (10%	Si Si	By Balance b/d (1.4.2004)	17,000
on Share capital of	deficiency	By Profit earned	In location
Rs. 50,000)	5,000	(Balancing figure)	28,000
To Loss of stock destroyed			
by fire (8,000 - 5,000)	3,000		
To Balance c/d (31.3.2005)	37,000		and the same of th
	45,000		45,000

(3) Loss on Revaluation of Machinery

	Rs.
Written down value on 1.7.2004	
Balance on 1.4.2004	30,000
Less : Depreciation for first 3 months $(30,000 \times 10\% 3/1)$	2) 750
Country Busheville and Australia and Austral	29,250
Less: Revalued figure	25,250
	4,000

Note : Rate of depreciation = $[(30,000-27,000) \times 100]/30,000 = 10\%$ p.a.

(4) Analysis of Profits of Y Ltd.

			Capital Profit	Revenue P & L
			Rs.	Rs.
Reserve on 1.4.2004 (As there on change		8		
during the year)		12,000	HE IN	
Profit & Loss A/c on 1.7.2004:		to remed	une sano sa	n que bis
Balance on 1.4.2004	*	17,000	Jeluste ni	all land
Add: Profit for first 3 months			ester la su	
(28,000 × 3/12)	7,000		British David	
Less: Interim dividend for first 3 months	2,500	4,500	21,500	
		To Time of	33,500	
Less : Revaluation loss of Machinery			4,000	
		*	29,500	
Profit for last 9 months (28,000 × 9/12)	For the sa	21,000	S Forefiller	
Add: Over depreciation on Machinery for				
last 9 months (4,000 × 10% × 9/12)		300		
91,48		21,300	1005	en sond si
Less: Loss of stock during last 9 months	3,000	End (Same	and the second	
Interim dividend for next 3 months	2,500	5,500		15,800
			29,500	15,200
Less : Share of minority (40%)		Best .	11,800	6,320
Share of X Ltd.			17,700	9,480

(5) Cost of Control

	Amount	Amount
Cost of investment	Rs.	Rs. 90,000
Less: Share of pre-acquisition interim dividend wrongly credited to the Profit & Loss A/c (2,500 × 60%)	ungi bah	1,500
True cost of investment		88,500
Less: Paid up value of 3,000 shares of Rs.10 each Share of capital profit	30,000 17,700	47,700
Goodwill		40,800

(6) Minority Interest

	product of the	Amount	Amount
Paid up	value of 2,000 shares of Rs.10 each	Rs.	Rs. 20,000
Add:	Share of capital profit	11,800	h - nulsi
	Share of revenue P & L including final proposed dividend	6,320	18,120
Less:	Share of final proposed dividend for minority only	a minima de de	ownt was
	(50,000 × 12% × 40%)		2,400
		Learn borne	35,720

(7) Consolidated Profit & Loss A/c (X Ltd.)

	Amount
	Rs.
Balance on 31.3.2005	80,000
Less: Share of pre-acquisition interim dividend wrongly credited to	241 42 42
the Profit & Loss A/c (2,500 x 60%)	1,500
Michael Michael Committee (1997)	78,500
Add: Share of revenue Profit & Loss A/c	9,480
	87,980

Illustration 7:

On April 1, 2002 A Ltd. acquired shares and debentures in B Ltd. The Balance Sheets of both the companies as at March 31, 2005 are given below:

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
OSERIAVIT.	Rs.	Rs.	DOMES.	Rs.	Rs.
Share Capital			Fixed Assets		
Eq. Shares (Rs. 100)	1,00,000	50,000	Sundry Fixed Assets	62,400	80,000
8% Pref. Shares	and but	able of	Investments		
(Rs. 100)	50,000	30,000	400 Eq. Sh. in B Ltd.	66,000	
Reserves & Surplus	(alvag., es	W L DEEP .	180 Pref. " " " "	18,000	4
Reserve	20,000	20,000	40 Deb. " " "	3,600	
Profit & Loss A/c	25,000	22,000	200 Eq. " " X Ltd.	19,000	
Secured Loans			(minority holding)		
9% Debentures			Currernt Assets	797	SHIP IN
(Rs. 100)		20,000	Loan to B Ltd.	6,000	1972/152
Current Liabilities	TI BURSON A	Brienings 1	Stock 15,000	23,000	W HEAT
Creditors	5,000	4,000	Debtors	8,000	31,000
Loan from A Ltd.	35.300	6,000	Bank 2,000	18,000	
	2,00,000	1,52,000	MAN PRELIMA	2,00,000	1,52,000

Additional information:

- (1) At the time of acquiring shares and debentures, B Ltd. had Rs.16,000 in Reserve and Rs.14,000 in Profit & Loss A/c (Credit balance).
- (2) In addition to preference dividend, B Ltd. paid equity dividend 10% in 2002-03, 12% in 2003-04 and 15% in 2004-05 for 2001-02, 2002-03 and 2003-04 respectively. All dividends received have been credited to the Profit & Loss A/c of A Ltd.
 - (3) Proposed equity dividend of both the companies for 2004-05 is 10%.
- (4) During 2002-03, a bonus dividend of one fully paid equity share for every 5 shares held has been declared by B Ltd. out of pre-acquisition reserve. No effect has been given to that in the accounts.
- (5) On April 1, 2002 Machinery of B Ltd. which stood in the books at Rs.50,000 was revalued at Rs.60,000, but no adjustment has been made in the books. Depreciation has been charged @ 10% p.a. on reducing balance method.

Prepare Consolidated Balance Sheet as on March 31, 2005.

Solution

Consolidated Balance Sheet of A Ltd. and its subsidiary, B Ltd. as on March 31, 2005.

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital :	LobsuP V	Fixed Assets	
Authorised	?	Sundry Fixed Assets	
Issued and Subscribed	NO MARK	(62,400 + 80,000) 1,42,400	
Equity Shares (Rs. 100)	1,00,000	Add: Rev. profit 10,000	
8% Pref. Shares (Rs. 100)	50,000	1,52,400	C Cated
Reserves & Surplus	Sec. 1012	Less: Under-dep. 2,710	1,49,690
Capital Reserve	6,720	Investments	
Reserve	32,200	[200 Equity Shares in X Ltd.	300
Profit & Loss A/c	9,912	(minority holding)]	19,000
Secured Loans	avone de	Current Assets, Loans and	Condition
9% Debentures 20,000		advances	CON DECK
Less: Held by A Ltd. 4,000	16,000	Loan to B Ltd. 6,000	
Current Liabilities &		Less: Inter-co. debt 6,000	Ni
Provisions		Stock (15,000 + 23,000)	38,000
Creditors (5,000 + 4,000)	9,000	Debtors (8,000 + 31,000)	39,000
Loan from A Ltd. 6,000		Bank (2,000 + 18,000)	20,000
Less: Inter-co. debt 6,000	Nil	be the tile same and a consideration	
Minority Interest	30,658	10 - 13 - 1000 no 173 f but 35 450	La marka
Proposed dividend:	ייי נוג וייטו	collections must be a first be the	18 CL R
A Ltd. 10,000		and is bout the sampatered	Hagy.
B Ltd. (Eqminority) 1,200	11,200	Library would be added to the	
	2,65,690		2,65,690

Working Notes:

(1) Proportion of holding (investment in equity shares is the deciding factor) in B Ltd.:

A Ltd.
$$= 400/500 = 4/5$$
ths $= 80\%$

Minority =
$$100/500 = 1/5^{th} = 20\%$$

(2) Pre-acquisition dividend (dividend paid in 2002-03 for 2001-02):

La Sujent conjuntori	Preference	Equity
	Rs.	Rs.
Dividend paid on pref. share capital (30,000 × 8% and 10% on equity share capital (50,000 × 10%)	2,400	5,000
Less : Share of minority		
Preference = Rs. 2,400 × (120/300)	960	N. A. C.
Equity = Rs.5,000 × 20%		1,000
Share of A Ltd.	1,440	4,000

(3) Proposed dividend of B Ltd. for 2004-05:

Over II Elepotation Connection	Preference	Equity
Equity share capital before issue of bonus shares on 1.4.2002 Add: Issue of bonus shares (50,000 × 1/5)	Rs.	Rs. 50,000 10,000
Equity share capital after issue of bonus shares on 1.4.2002 Proposed dividend on pref. share capital (30,000 × 8%)		60,000
and on enhanced equity share capital (60,000 × 10%) Less: Share of minority [(2,400x120/300) and	2,400	6,000
(6,000 × 20%)]	960	1,200
Share of B Ltd.	1,440	4,800

(4) Analysis of Profits of B Ltd.

2 In the second of the second	Capital Profit	Revenue Gen. Res.	Revenue P & L
	Rs.	Rs.	Rs.
Reserve on 1.4.2002 (including issue of bonus			
Shares, Rs.10,000)	16,000		
Increase in Reserve after acquisition of shares but			
before issue of bonus shares (20,000—16,000)	the the	4,000	
Profit & Loss A/c on 1.4.2002 14,000		***	
Less : Pre-acquisition dividend		R Spiles	
(1,440 + 5,000) 6,400	7,600		

respire the control of the control of the tenter de	Capital Profit	Revenue Gen. Res,	Revenue P & L
	Rs.	Rs.	Rs.
Increase in Profit & Loss A/c after acquisition of shares (22,000—7,600) Profit on revaluation of Machinery	pras sent 3 Integrio topica Trans	og socialis Originalis United Spek	14,400
(60,000—50,000)	10,000		
	33,600	4,000	14,400
Less : Over-depreciation on Machinery [(10,000—(10,000 × 90% × 90% × 90%)]	I den unsk		2,710
	33,600	4,000	11,690
Less : Share of minority (20%)	6,720	800	2,338
Share of B Ltd.	26,880	3;200	9,352

(5) Cost of Control:

	Amount	Amount
and was a languaged to a second and a second and	Rs.	Rs.
Investment in B Ltd. :	nopim tasi	
400 Equity Shares	66,000	
180 Preference Shares	18,000	
40 Debentures	3,600	87,600
Less: Share of pre-acquisition dividend wrongly credited to		
the Profit & Loss A/c (1,440 + 4,000)		5,440
True cost of investment	050000	82,160
Less: Paid up value of Equity Shares	40,000	
Paid up value of Preference Shares	18,000	
Paid up value of Debentures	4,000	2 100
Share of capital profit	26,880	88,880
Capital Reserve	1000	6,720

(6) Minority Interest

	Pref.	Equity	Total
currences were not common called an in the comment.	Rs.	Rs.	Rs.
Paid up value of shares :	untak di S		
Preference (120 × 100)	12,000		12,000
Equity (100 × 100)	and the	10,000	10,000
Add: Share of capital profit	aream M	6,720	6,720
Share of revenue profit :		Soft dive	U.S. Lin
Reserve	800	800	
Profit & Loss (including equity proposed div.)		1,378	1,378*
Proposed preference dividend	960	of Treats	960
(as it is not subject to approval)	12,960	18,890	31,858
Less : Share of equity proposed div. for minority		1,200	1,200
(since it is subject to approval)	12,960	17,698	30,658

^{*}Share of revenue profit & loss is arrived at after deducting current year's proposed preference dividend for outsiders, i.e., Rs. (2,338—960).

(7) Consolidated Reserves & Surplus

and the state of the second state of the secon	Reserve	P & L
	Rs.	Rs.
Balance in the respective accounts of A Ltd. on 31.3.2005	20,000	25,000
Less: Share of pre-acquisition dividend wrongly credited	.,	
to the Profit & Loss A/c previously	Day month	5,440
	20,000	14,560
Add: Share of revenue profit	3,200	9,352
Andrew Complete Compl	. 23,200	23,912
Less : Proposed dividend (preference & equity) of A Ltd.	The para or	
[(50,000 × 8%) + (1,00,000 × 10%)]		14,000
TO SERVICE THE CONTROL OF STREET OF STREET S	23,200	9,912

6.7 Consolidated Profit and Loss Account

The consolidated profit and loss account of the holding company and its subsidiaries is prepared to show the comprehensive operating activities of the companies comprising the group. All revenue items, i.e., purchases, sales, expenses, incomes, etc. are to be added on line by line basis, on one hand and all inter-company revenue items should be eliminated, on the other. Moreover, following adjustments are essential:

- (1) The profit of the subsidiary company arising before the date of acquisition (of equity shares in the subsidiary company) and belonging to the holding company should be debited to the Consolidated Profit and Loss Account and credited either to Capital Reserve or Goodwill as the case may be. In case of loss, the journal entry should be reversed.
- (2) Profits of the subsidiary company to the extent of the proportion of the outside shareholders should be debited to Consolidated Profit and Loss Account and credited to Minority Interest Account. In case of loss, the journal entry is reverse.
- (3) Where the subsidiary company has passed entries for proposed dividend and the holding company has also taken credit for its share of the dividend, cancellation from both sides of the Consolidated Profit and Loss Account should be made. This will also affect items in the Balance Sheet. Where the proposed dividend has not been passed in the books of holding company, the debit in respect of proposed dividend should be reduced to the extent of the share of holding company in the Consolidated Profit and Loss Account; and the corresponding liability in the Balance Sheet be reduced.
- (4) Provision for unrealised profit in respect of inter-company transactions, such as purchase or sale of goods or assets will have to be made by debit to the Consolidated Profit and Loss Account and credit to Provision for Stock or Provision for particular Fixed Asset Account.
- (5) Debenture interest or dividend received by the holding company from the subsidiary company will have to be eliminated from both sides of the Consolidated Profit and Loss Account. In case of interest outstanding or accruing, care should be taken to see that both the holding company and subsidiary companies pass entries.

No adjustment is required in respect of tax on dividend or on interest on debentures paid by the subsidiary company to the holding company.

(6) In the case of Cumulative Preference Shares held by outsiders and in the case where dividend is in arrear, the amount due by way of dividend should be debited to the Consolidated Profit and Loss Account and credited to the Minority Interest Account. This will be shown as a liability in the Consolidated Balance Sheet.

Illustration 8:

A Ltd. held 1,200 shares of B Ltd. which it acquired on April 1, 2004. Total capital of B Ltd. comprised 1,500 equity shares of Rs.100 each. The Profit and Loss Accounts of A Ltd. and B Ltd. for the year ended March 31, 2005 appeared as under:

	A Ltd.	B Ltd.		A Ltd.	B Ltd.
To Proposed	Rs.	Rs.	By Net profit	Rs. 24,000	Rs. 18,000
dividend	Nil	15,000	By Dividend receiv-	24,000	10,000
To Balance c/d	36,000	3,000	able from B Ltd.	12,000	Nil
	36,000	18,000		36,000	18,000

Prepare a Consolidated Profit and Loss Account for the year ended March 31, 2005.

Solution

Consolidated Profit and Loss Account for the year ended March 31, 2005

The state of the s	A Ltd.	B Ltd.	Total	Adjust- ment	Net Amount
Debit items	Rs.	Rs.	Rs.	Rs.	Rs.
To Proposed dividend To Minority Interest	-	15,000	15,000	(12,000)	3,000
(3000 × 20%)		GUALUE -	201000	600	60
To Balance c/d	36,000	3,000	39,000	(600)	38,400
	36,000	18,000	54,000	(12,000)	42,000
Credit items By Net profit By Dividend receivable	24,000	18,000	42,000		42,000
from B Ltd.	12,000		12,000	(12,000)	
	36,000	18,000	54,000	(12,000)	42,000

Note: Figures in parentheses indicate minus figure.

Illustration 9:

X Ltd. holds 1,500 Equity Shares of Rs.100 each in Y Ltd. whose capital consists of 2,000 Equity Shares of Rs.100 each and 6% 500 Cumulative Preference Shares of Rs.100 each. Y Ltd. has also issued 7% Debentures to the extent of Rs.100,000 out of

which X Ltd holds Rs.50,000. The following are the Profit and Loss Accounts of the two companies for the year ended March 31, 2005:

Harologic In Linear	X Ltd.	Y Ltd.	gerand gerealities	X Ltd.	Y Ltd.
	Rs.	Rs.	Carrier Carrier	Rs.	Rs.
To Purchases			By Sales	9,50,000	7,50,000
(adjusted)	7,50,000	3,00,000		1.00	the box
To Manufacturing	E on hold	id (8)		- Let	
expenses		2,00,000		1000	
To Gross profit c/d	2,00,000	2,50,000			
and a femiliar to the	9,50,000	7,50,000	S at how there's boat is	9,50,000	7,50,000
To Sundry expenses	75,000	1,00,000	By Gross profit b/d	2,00,000	2,50,000
To Deb. interest	in besiden	7,000	By Dcb. interest	3,500	1eng3
To Net profit c/d	1,49,500	1,43,000	By Interim dividend	21,000	_
	2,24,500	2,50,000	(gross)	2,24,500	2,50,000
To Income tax	70,000	60,000	By Net profit b/d	1,49,500	1,43,000
To Pref. dividend	_	3,000		The state of	
To Interim dividend)100 P	28,000		Market State	GOET OF
To Proposed div.	50,000	42,000			3500
To Balance c/d	29,500	10,000	10035	1 Schie	n lister or
Social March	1,49,500	1,43,500	11 10 F	1,49,500	1,43,000

Additional information is given as below:

- (a) The shares were acquired by X Ltd. on July 1, 2004 but the debentures were acquired on April 1, 2004. Y Ltd. was incorporated on April 1, 2004.
 - (b) The income tax deducted from dividends and interest is @ 30%.
- (c) During the year Y Ltd. sold to X Ltd. goods costing Rs.50,000 at the selling price of Rs.60,000. One-fourth of the goods remained unsold on March 31, 2005. The goods were valued at cost to the holding company for closing stock purposes.

Prepare a Consolidated Profit and Loss Account for the year ended March 31, 2005.

Solution

Consolidated Profit and Loss Account for the year ended March 31, 2005

e a	00000 17 × 0000 11 13	A Ltd.	B Ltd.	Total	Adjust- ment	Net Amount
Here		Rs.	Rs.	Rs.	Rs.	Rs.
	Debit items				OR THE	
То	Purchases (adjusted)	7,50,000	3,00,000	10,50,000	(75,000)	9,75,000
То	Manufacturing expenses	_	2,00,000	2,00,000	-	2,00,000
То	Gross profit c/d	2,00,000	2,50,000	4,50,000	_	4,50,000
	or sillyworthout the country	9,50,000	7,50,000	17,00,000	0.1	16,25,000
То	Sundry expenses	75,000	1,00,000	1,75,000		1,75,000
То	Debenture interest	n ne de	7,000	7,000	(3,500)	3,500
То	Net profit c/d	1,49,500	1,43,000	2,92,500	(21,000)	2,71,500
		2,24,500	2,50,000	4,74,500	(24,500)	4,50,000
То	Income tax	70,000	60,000	1,30,000	milita m	1,30,000
То	Preference dividend		3,000	3,000	and the	3,000
То	Interim dividend	PER BUILDING	28,000	28,000	(21,000)	7,000
То	Proposed dividend	50,000	42,000	92,000	(31,500)	60,500
То	Cost of control (cap. profit)				15,000	15,000
То	Provision for stock		STAR STA	Contract as	2,500	2,500
То	Minority interest				2,750	2,750
То	Balance carried over to B/S	29,500	10,000	39,500	11,250	50,750
		1,49,500	1,43,000	2,92,500	(21,000)	2,71,500
	Credit items	e ul la via	Since Joseph			
Ву	Sales	9,50,000	7,50,000	17,00,000	(75,000)	16,25,000
	or the lade of the design of	9,50,000	7,50,000	17,00,000	(75,000)	16,25,000
Ву	Gross profit b/d	2,00,000	2,50,000	4,50,000	gella De-	4,50,000
Ву	Debenture interest	3,500	1	3,500	(3,500)	
Ву	interim dividend received	21,000	-14	21,000	(21,000)	ringitude.
	oriz symptothalada karen skor	2,24,500	2,50,000	4,74,500	(24,500)	4,50,000
Ву	Net profit b/d	1,49,500	1,43,000	2,92,500	(21,000)	-2,71,500

- Notes: (1) Figures in the brackets indicate minus figure.
 - (2) Dividend received by X Ltd. has been eliminated against interim dividend paid by Y Ltd.
 - (3) Proposed dividend includes Rs. 31,500 (i.e., Rs. 42,000 × ¾] payable to X Ltd. by Y Ltd. This is also eliminated. The corresponding elimination on the other side will be from the liability for Proposed Dividend in the Balance Sheet, since X Ltd. has not yet taken credit for the proposed dividend.
 - (4) Share of capital profit : [Rs. $(1,43,000 60,000 3,000) \times \frac{1}{4} \times \frac{3}{4}$] = Rs. 15,000
 - (5) Provision for stock: (Rs.10,000 × $\frac{1}{4}$) = Rs. 2,500
 - (6) Assumed that the dividends have been paid or proposed from revenue profits.

6.8 Group Consisting of more than one Subsidiary—Chainholding

A holding company may have a number of subsidiaries. For example, X Ltd. directly acquires controlling interest in A Ltd. and B Ltd. Thus, A Ltd. and B Ltd. are the subsidiaries of X Ltd. Other examples of chain-holding are:

- (a) X Ltd. acquires controlling interest in A Ltd., and A Ltd. acquires controlling interest in B Ltd.;
- (b) X Ltd. acquires controlling interest in A Ltd. while X Ltd. and A Ltd. jointly acquire controlling interest in B Ltd.;
- (c) X Ltd. acquires majority shares of A Ltd. and minority shares of B Ltd., while A Ltd. individually acquires majority shares of B Ltd.; and
- (d) X Ltd. acquires majority shares of A Ltd., and A Ltd. acquires majority shares of B Ltd. but B Ltd. acquires minority shares of A Ltd.

In the case of chain-holding, a holding company is not only entitled to the profits of its own subsidiary but is also entitled to the profits of sub-subsidiary which it may control through its own subsidiary. The principles for consolidation will be the same as explained in the preceding pages.

Illustration 10:

You are asked to prepare from the following data the Consolidated Balance Sheet of a group of companies:

Balance Sheets as at March 31, 2005

(Rs. in lakh)

Liabilities	AX Ltd.	BX Ltd.	CX Ltd.	Assets	AX Ltd.	BX Ltd.	CX Ltd.
Share Capital	250	200	100	Sundry Fixed Assets	50	80	55
Reserve	36	20	14	Investments at cost :			
Profit & Loss A/c	32	4	10	Shares in BX Ltd.	170	99-	
Creditors	14	10	8	Shares in CX Ltd.	36	106	
CX Ltd. balance	6	- 6	11112	Stock	24	20	28
AX Ltd. balance	_	14		Debtors	36	32	45
Bank overdraft	_	-	2	BX Ltd. balance	16	_	<u> </u>
			(34L)	AX Ltd. balance	s		6
	u lasti r	in times	Sup 1	Bank balance	6	10	Store .
	338	248	134		338	248	134

Information regarding AX Ltd. and its subsidiaries, BX Ltd. and CX Ltd. are as follows:

- (1) The share capital of all companies is divided into shares of Rs.100 each.
- (2) AX Ltd. held 1,50,000 shares of BX Ltd. and 15,000 shares of CX Ltd.
- (3) BX Ltd. held 60,000 shares of CX Ltd.
- (4) All investments were made on September 30, 2004.
- (5) On April 1, 2004, the position of reserves and surplus was as follows:

	BX Ltd.	CX Ltd.
Reserve	Rs.16,00,000	Rs.12,00,000
Profit & Loss Account	2,00,000	80,000

- (6) Dividends have not been declared by any company during the year ended March 31, 2005.
- (7) BX Ltd. sold goods for Rs.8,80,000 to AX Ltd. at a profit of 10% on cost and remained unsold on March 31, 2005.
- (8) Cash-in-transit from BX Ltd. to AX Ltd. was Rs.2,00,000 as on the close of business on March 31, 2005.

Solution

Consolidated Balance Sheet of AX Ltd. and its subsidiaries, BX Ltd. and CX Ltd. As at March 31, 2005

(Rs. in lakh)

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital :	Life in	node 1	Fixed Assets	50 A 2007	
Authorised	11250	?	Goodwill		60.21
Issued & Subscribed		Line	Sundry Fixed Assets	SOUTH	Bull Xo
Sh. of Rs.1000 each		250.00	(50 + 80 + 55)	Supplied.	185.00
Reserves & Surplus	Sandon	61.711	Investments	theire	10 No.
Reserve	aparties.	38.10	Current Assets,		
Profit & Loss A/c	i sail	34.91	Loans and Advances		
Current Liabilities			Stock (24 + 20 + 28)	72.00	
and Provisions	20		Less: Prov. for stock	0.80	71.2
Minority Interest		90.40	Debtors (36+32+45)		113.0
Creditors (14+10+8)		32.00	BX Ltd. balance	16.00	
Bank Overdraft	Carry Carry	2.00	Less: Inter-co, debt	14.00	
CX Ltd. balance	6.00		HE STATE OF A SECOND	2.00	
Less: Inter-co. debt	6.00	- 2	Less: Cash-in-transit	2.00	\$ <u></u>
AX Ltd. balance	14.00		AX Ltd. balance	6.00	6/2
Less: Inter-co. debt	14.00	TRONG BET	Less: Inter-co. debt	6.00	6
Link X			Cash-in-transit		• 2.0
GOLDON STEELS	e and		Bank balance (6 + 10)	S - 50	16.0
100,02	447.41		140.845	User I &	447.4

Working Notes :

(1) Break up of Control:

In CX Ltd.—

In BX Ltd.—

AX Ltd. = (15,000)/(1,00,000)=15%

AX Ltd. = (1,50,000)/(2,00,000) = 75%

BX Ltd. = (60,000)/(1,00,000)=60%

Minority = (50,000)/(2,00,000) = 25%

Minority = (25,000)/(1,00,000)=25%

(2) Analysis of Profits

(Rs. in lakh)

			Capital	Revenue	Revenue
312.00			Profit	Gen. Res.	P & L
CX Ltd.		Ph mode		relies on B	E can a
Reserve or	1 30.9.2004 :			Bun 1016	SSI .
Balance or	1 1.4.2004	12.00		ingl 1 10 mg	R. I
	acrease during first 6 months 4—12) × ½]]	1.00	13.00	izit bili ki milibili X	
Increase in	Reserve during last 6 months			1.00	Law Keek
Profit & L	oss A/e on 30.9.2004 :			et il conomi	4
Balance or	n 1.4.2004	0.80		2 Company	0.00
Add: Ir	crease during first 6 months				
[(10—0.80) × ½]	4.60	5.40		
Increase in	P & L A/c during last 6 months	s		With the Cartin	4.60
			18.40	1.00	4.60
Less: S	hare of AZ Ltd. (15%)		2.76	0.15	0.69
S	hare of minority (25%)		4.60	0.25	1.15
Share of I	BX Ltd. (60%)		11.04	0.60	2.76
BX Ltd.	De la companya de la				
Reserve or	n 30.9.2004 [16+(20—16) × 1/2]	*	18.00	mada lik guni	aier.
	Res. during first 6 months			2.00	
Profit & I	oss A/c on 30.9.2004 [2+(4-2)	× ½]	3.00	Int. E. E. S	Several
Increase in	Profit & Loss A/c during last 6 [(4-2) × ½]	months	erd piece	as la comi	1.00
		a garding	32.04	2.60	3.76
	er-co. unrealised stock profit × (10)/(110)]				0.80
			32.04	2.60	2.96
Less: Sha	are of minority (25%)	- eligibary	8.01	0.65	0.74
Share of	AX Ltd. (75%)	a Section	24.03	1.95	2.22

(3) Cost of Control

(Rs. in lakh)

when 8 removal a rite	Amount	Amount	Amount
Cost of Shares (170 + 36 + 106)			312.00
Less: Paid up value of 2,25,000 shares of			
Rs.100 each		225.00	
Share of Capital Profit :		100-510	
AX Ltd. from BX Ltd.	24.03		
AX Ltd. from CX Ltd.	2.76	26.79	251.79
Goodwill			60.21

(4) Minority Interest

(Rs. in lakh)

	BX Ltd.	CX Ltd.	Total
Paid up value of shares	50.00	25.00	75.00
Add: Share of Capital Profit	8.01	4.60	12.61
Share of Revenue Profit :			
Reserve	0.65	0.25	0.90
Profit & Loss A/c	0.74	1.15	1.89
	59.40	31.00	90.40

(5) Group Reserves & Surplus

(Rs. in lakh)

		Reserve	P & L
Balance	of AX Ltd. on 31.3.2005	36,00	32.00
Add:	Share of Revenue Profit:		
	alance of AX Ltd. on 31.3.2005 dd: Share of Revenuc Profit: AX Ltd. from BX Ltd. AX Ltd from CX Ltd.	1.95	2.22
	AX Ltd from CX Ltd.	0.15	0.69
		38.10	34.91

Illustration 11:

From the following Balance Sheets and other information prepare Consolidated Balance Sheet of the group of companies :

Balance Sheets as at March 31, 2005

(Rs. in thousand)

Liabilities	Α	В	C	Assets	A	В	C
4	Ltd.	Ltd.	Ltd.		Ltd.	Ltd.	Ltd.
Equity Share Capital	600	400	200	Goodwill at cost	40		_
(Rs. 100 each)		200	III SSEE	Sundry Fixed Assets	300	200	240
Profit & Loss A/c	160	100	62	Investments:			
Creditors	20	24	10	3,000 shares in B Ltd.	320		_
				1,600 shares in C Ltd.	-	200	_
				Stock-in-trade	60	20	10
				Debtors	46	57	20
				Cash at Bank	14	27	2
	780	524	272		780	524	272

Other Information :	A Ltd.	B Ltd.	C Ltd
(1) Profit & Loss A/c (Credit balance) on			
1.4.2004 before taking proposed dividend	Rs.80,000	Rs.48,000	Rs.4,000
(2) On 1.7.2004 dividend paid for the year			
ended 31.3.2004	12%	10%	10%
(3) Dividends proposed for the year ended			

(4) All shares were acquired on 1.4.2004.

31.3.2005 out of current year's profit

(5) A Ltd. and B Ltd. credited dividend received to their Profit & Loss Accounts.

12%

10%

8%

Solution

Consolidated Balance Sheet of A Ltd. and its subsidiaries, B Ltd. and C Ltd.

As at March 31, 2005

(Rs. in thousand)

Liabilities	Amount	Amount	Assets	Amount	Amount
Share Capital Authorised		7	Fixed Assets Goodwill		
Issued & Subscribed			(40.00 + 5.60)		45.60
Equity Shares of Rs. 100 each Reserves & Surplus		600.00	Sundry Fixed Assets (300 + 220 + 240) Investments		760.00

Liabilities	Amount	Amount	Assets	Amount	Amount
Profit & Loss A/c		145.80	Current Assets,		
Current Liabilities	2 Alltul		Loans and Advances		ME TO
and Provisions			Stock-in-trade		
Creditors	100	- Don's	(60 + 20 + 10)		90.00
(20 + 24 + 10)	North India	54.00	Debtors		
Minority Interest		176.60	(46 + 57 + 20)		123.00
Proposed Dividend:			Cash at Bank		2000000
A Ltd.	72.00		(14 + 27 + 2)		43.00
B Ltd.	10.00				0.53484
C Ltd. (minority only)	3.20	85.20			
		1061.60			1061.60

Working Notes:

(1) Break-up of Control:

In C Ltd.—

In B Ltd.—

B Ltd. = (1,600)/(2,000) = 80%

A Ltd. = (3,000)/(4,000) = 75%

Minority = (400)/(2,000) = 20%

Minority = (1,000)/(4,000) = 25%

(2) Analysis of Profits

	Details	Capital Profit	Revenue P & L
	Rs.	Rs.	Rs.
C Ltd.			
Profit & Loss A/c on 1.4.2004	24,000		
Less: Dividend paid for 2003-04 @ 10%	20,000		
Increase in Profit & Loss A/c during 2003-04		4,000	
(62,000 – 4,000)			58,000
		4,000	58,000
Less : Share of minority (20%)		800	11,600
Share of B Ltd. (80%)		3,200	46,400
B Ltd.	Tanana T		
Profit & Loss A/c on 1.4.2004	48,000		No.
Less: Dividend paid for 2003-04 @ 10%	40,000	8,000	
Increase in Profit & Loss A/c during 2004-05			
(1,00,000 - 8,000)			92,000
State of Part Application		11,200	1,38,400
Less : Share of minority (25%)		2,800	34,600
Share of A Ltd. (75%)		8,400	1,03,800

(3) Cost of Control

		Amount	Amount
		Rs.	Rs.
Cost of	Investments (3,20,000 + 2,00,000)	and seemos	5,20,000
Less:	Dividend for 2002-03 received and wrongly	ii oo Laka y	S varietino
	credited to the Profit and Loss A/c in 2004-05:	prome St	Sind are
	A Ltd. from B Ltd. (40,000 × 75%)	30,000	
	B Ltd. from C Ltd. (20,000 × 80%)	16,000	46,000
True co	ost of investments	Heart Hay	4,74,000
Less:	Paid-up value of 4,600 shares of Rs.100 each	4,60,000	Red Salining
	Share of capital profit	8,400	4,68,400
Goodwi	Le al le forme de la mai la destruit de la macella de la comi	entan majip) i	5,600

(4) Minority Interest

	B Ltd.	C Ltd.	Total
Paid-up value of shares of Rs.100 each	1,00,000	40,000	1,40,000
Add: Share of capital profit	2,800	800	3,600
Share of revenue profit	34,600	11,600	46,200
Less : Share of proposed dividend :	1,37,400	52,400	1,89,800
B Ltd. (4,00,000 × 10% × 25%)	10,000	UD (0)	10,000
C Ltd. (2,00,000 × 8% × 20%)	1,27,400	49,200	1,76,600

(5) Group Profit and Loss Account

	Amount	Amount
CONSTRUCTION OF THE PART OF TH	Rs.	Rs.
Profit & Loss A/c of A Ltd. on 31.3.2005		1,60,000
Add: Share of revenue Profit & Loss A/c	= (4(00))))	1,03,800
or an investment of the state o		2,63,800
Less: Dividend for 2003-04 received and wrongly credited	No. Trapes	
to the Profit & Loss A/c	46,000	
Proposed dividend of A Ltd. (6,00,000 × 12%)	72,000	1,18,000
		1,45,800

6.9 Summary

Preparation of consolidated balance sheet and consolidated profit and loss account by the holding company is not mandatory in India under the Companies Act, 1956. However, the Act stipulates the presentation of accounts of subsidiary companies by the holding company. But AS-21requires compulsory preparation of consolidated financial statement by the holding company for a group of companies under its control in addition to its separate financial statement. Moreover, the Standard provides the procedure of consolidation. The Standard also prescribes the disclosure requirements of the consolidated financial statement Thus, preparation of consolidated financial statement by the holding company along with its own financial statement is essential to the users of financial information of holding company for taking useful economic decisions. In the light of preparation and presentation of financial statement by the holding company, the Standard is superior to the Act—the latter deals not only with the preparation and presentation but also deals with the disclosure requirements while the former deals with the legal aspects of its preparation and presentation.

6.10 Exercises

Problem 1:

X Ltd. purchased 600 out of 1,000 Equity Shares of Rs.100 each of Y Ltd. at a cost of Rs.96,000 on July 1, 2004. The Profit and Loss Account of Y Ltd. on April 1, 2004 was Rs.40,000 and made a profit of Rs.24,000 during the year ended March 31, 2005.

Determine (i) Cost of Control and (ii) Minority Interest.

Answer: (i) Goodwill Rs.8,400 and (ii) Rs.65,600.

Problem 2:

HB Ltd. acquired 2,000 shares in SB Ltd. on October 1, 2004. The Balance Sheets as at March 31, 2005 were as under:

Liabilities	HB Ltd.	SB Ltd.	Assets	HB Ltd.	SB Ltd.
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital			Buildings	1,15,000	1,50,000
(Rs. 100 each)	5,00,000	2,50,000	Machinery	1,90,000	1,35,000
Reserve (1.4.2004)	1,55,000	10,000	Investments in 2,000	100 200	7. 7.
Profit & Loss A/c	2,00,000	1,80,000	shares SB Ltd.	3,60,000	
Creditors	75,000	70,000	Stock-in-trade	1,24,000	1,01,000
Current Account	11		Debtors	1,16,000	80,000
with SB Ltd.	14,000	_	Bills Receivable	20,000	20,000
Bills Payable	6,000	10,000	Current Account		
To be a series		9g 7 3 000	with HB Ltd.	_	16,000
			Cash at Bank	25,000	18,000
	9,50,000	5,20,000		9,50,000	5,20,000

Other information:

- (1) The balance in Profit & Loss Account of SB Ltd. on April 1, 2004 was Rs. 1,40,000.
- (2) An interim dividend @ 10% was paid during the year ended March 31, 2005.
- (3) Stock-in-trade of HB Ltd. includes Rs.15,000 for goods supplied by SB Ltd. at a profit of 25% on cost.
 - (4) The Profit & Loss Account of HB Ltd. includes interim dividend from SB Ltd.
- (5) The difference in Current Account arises on account of cheque sent by HB Ltd. but not reached SB Ltd.
- (6) Blls Payable of SB Ltd. are all issued in favour of HB Ltd., out of which HB Ltd. discounted bills for Rs. 6,000.

Answers: Goodwill Rs. 14,000; Minority interest Rs. 88,000; Consolidated Profit & Loss A/c Rs. 2,03,600 and total of Balance Sheet Rs. 11,03,000.

Problem 3 :

X Ltd. purchased control of Y Ltd. on July 1, 2004. Following are Balance Sheets of two companies as at March 31, 3005:

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
	Rs.	Rs.		Rs.	Rs.
Equity Share Capital			Land & Buildings	66,000	84,000
(Rs.100 each)	3,60,000	1,80,000	Plant & Machinery	1,20,000	1,08,000
Capital Reserve	-	10,000	Investments in 1,350		
General Reserve	36,000	40,000	shares of Y Ltd.	2,00,000	
Profit & Loss A/c	60,000	50,000	Stock	73,000	60,000
Creditors	60,000	32,000	Debtors	40,000	54,000
Bills Payable to X Ltd.	_	6,000	Cash at Bank	17,000	12,000
	5,16,000	3,18,000		5,16,000	3,18,000

The following further information is furnished:

- (1) Y Ltd. had on April 1, 2004 Rs.30,000 in General Reserve and Rs.36,000 (Credit balance) in Profit & Loss Account.
- (2) Y Ltd. paid 12% dividend out of pre-acquisition Profit & Loss Account. The share of dividend received by X Ltd. credited to its Profit & Loss Account.
- (3) In July, 2004 Y Ltd. issued bonus shares at par in the ratio of one share for every six shares held out of pre-acquisition General Reserve. No effect has been given to that in the above accounts.

- (4) Plant & Machinery standing in the books of Y Ltd. at Rs.1,20,000 on the date of purchase were revalued at Rs.1,37,000.
 - (5) Proposed dividend of both the companies for the year ended March 31, 2005 is 10%.
- (6) Creditors of Y Ltd. include Rs.14,000 due to X Ltd. while Debtors of X Ltd. include Rs.18,000 due from Y Ltd.
- (7) Stock of Y Ltd includes Rs.12,000 for goods purchased from X Ltd. which company made a profit of 20% on cost price.
 - (8) Contingent liability of X Ltd.Rs.8,000 for bills discounted.

Prepare a Consolidated Balance Sheet as at March 31, 2005.

Answers: Capital Reserve Rs.15,550; Minority Interest Rs.68,875 (excluding share of proposed dividend); Consolidated General Reserve Rs.41,625; Consolidated Profit & Loss A/c Rs.25,200; Proposed dividend for minority Rs.5,250; Remittance in transit Rs.4,000; Contingent liability for bills discounted (external) Rs.2,000 and total of Balance Sheet Rs.6,36,500.

Problem 4:

The summarised Balance Sheets of AL Ltd., BL Ltd. and CL Ltd. were as follows:

Balance Sheets as at March 31, 2005

(Rs. in lakh)

Liabilities	AL Ltd.	BL Ltd.	CL Ltd.	Assets	AL Ltd.	BL Ltd.	CL Ltd.
Equity Share Capital (Rs.100 each)	250	100	80	Fixed Assets Investments:	173	82	55
Profit & Loss A/c	30	20	2	80,000 shares in		- 6	
Loan from CL Ltd. ·		25	-	BL Ltd,	96	skind.	1
Other Liabilities	7	55	18	60,000 shares in	-		
				CL Ltd.	(t -12	55	-
			He B	Advances to BL Ltd.			35
	ST208	Justs	0 75 00	Current Assets	81	63	10
	350	200	100	a Camical (nato)	350	200	100

On April 1, 2004, when the above shares were acquired, BL Ltd. had a surplus of Rs.10 lakh and CL Ltd. had a deficit of Rs.6 lakh. On September 30, 2004, BL Ltd. sold an item of fixed assets, which had cost Rs.20 lakh, to AL Ltd. for Rs.25 lakh. Depreciation was charged at 10% p.a. on the book value of the asset.

Prepare a Consolidated Balance Sheet of the group as at March 31, 2005.

Answers (Rs. in lakh): Goodwill Rs.6.60; Minority Interest Rs.43.85; Consolidated Profit & Loss A/c Rs.39.00 and total of Balance Sheet Rs.475.85.

Problem 5 :

The Profit and Loss Account of ΛX td. and its subsidiary, BY Ltd. for the year ended March 31, 2005 are as follows:

Profit & Loss Accounts for the year ended March 31, 2005

60	ted and sold specific	AX Ltd.	BY Ltd.	ive with lot a we need	AX Ltd.	BY Ltd.
		Rs.	Rs.	no als any period from the land	Rs.	Rs.
To	Depreciation	15,000	4,500	By Balance b/d	47,250	18,000
То	Debenture			By Trading Profit	93,000	57,000
	Interest	12,000		By Dividend from		
To	Directors	Athen was		By Ltd. :		
	Emoluments	7,500	6,000	Preference	8,100	
То	Prov. for Tax	31,500	21,500	Equity	5,625	30
To	Dividend Paid:		-United			
	Pref. Sept 30	in the first	4,500			
	Mar 31		4,500			
	Equity: Sept 30	18,000	7,500		With the Land	100
	Mar 31	18,000	7,500	电影型的新发展	MI Process	
То	Balance c/d	51,975	19,000		to die	
10		1,53,975	75,000		1,53,975	75,000

The following information relates to share capital:

See See	AX Ltd.	BY Ltd.
	Rs.	Rs.
Equity shares of Rs.100 each fully paid	6,00,000	3,00,000
6% Preference shares of Rs.100 each fully paid	THE STREET	1,50,000
Shares in BY Ltd. held by AX Ltd.		
Equity shares acquired on October 1, 2004	and the state of t	2,25,000
Preference shares acquired on April 1, 2004	Bear S. F St. of	1,35,000

Income and expenditure are deemed to accrue evenly throughout the year. All dividends are payable out of the current year's profit.

Prepare Consolidated Profit and Loss Account for the year ended March 31, 2005.

Answers: Profit after taxation: AX Ltd. Rs.27,000 and BY Ltd. Rs. 25,000; Consolidated Profit & Loss: AX Ltd. Rs. 51,975, BY Ltd. Rs. 19,000 and the group Rs. 52,350, i.e., Rs. $[51,975+(25,000-24,000)\times6/12\times75\%]$; Minority Interest Rs. 4,750 and Pre-acquisition Profit Rs. 13,875.

6.11 Ouestions

- Q.1 What do you mean by a holding company? How does a company become holding company? Are the preparation of consolidated financial statements compulsory in India?
- Q.2 Discuss the principles of consolidation. Explain separately the accounting treatment for the purpose of consolidation on (i) Debentures and Preference Shares held by the holding company, (ii) Pre-acquisition dividend paid by the subsidiary company, (iii) Interim dividend paid by the subsidiary company partly out of capital profit and partly out of revenue profit, (iv) Issue of bonus shares by the subsidiary company out of post-acquisition profit, and (v) Unrealised profit on fixed asset purchased by subsidiary company from its parent company.
- Q.3 What are the legal requirements for the presentation of information by the holding company in respect of its subsidiary or subsidiaries?
- Q.4 Mention the requirements relating to the consolidation of financial statements as per the AS-21. Do you think that AS-21 is superior to the Companies Act, 1956 in the matter of preparation and presentation of consolidated financial statements?
- Q.5 Make a comparative analysis between the Companies Act, 1956 and AS-21 in the matter of preparation and presentation of consolidated financial statements.

6.12 Suggested Readings

- 1. Schedule VI of the Companies Act, 1956.
- 2. The Institute of Chartered Accountants of India: Accounting Standards 21.
- 3. Chakraborty, H: Advanced Accountancy, Oxford University Press.
- Shukla, M.C; Grewal, T. S. & Gupta, S. C: Advanced Accounts, S. Chand & Co. (Pvt.) Ltd.
- 5. Gupta, R. L. & Radhaswamy, M: Advanced Accounts, Sultan Chand & Sons.
 - Maheshwari, S. N. Advanced Accountancy, Volume II, Vikas Publishing House Pvt. Ltd.

Unit 7 ☐ Schemes for Mergers and Amalgamations and Internal Reconstructions

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- 7.0 Objective
- 7.1 Introduction
- 7.2 Meaning of Amalgamation and Merger
- 7.3 Accounting for Amalgamation
- 7.4 Types of Amalgamation
 - 7.4.1 Amalgamation in the nature of merger
 - 7.4.2 Amalgamation in the nature of purchase
- 7.5 Methods of Accounting
 - 7.5.1 Pooling of Accounting
 - 7.5.2 Purchase Method
- 7.6 Schemes for Mergers and Amalgamations
- 7.7 Outlines for Amalgamation Scheme
- 7.8 Scheme of Internal Reconstruction
 - 7.8.1 Circumstances of Internal Reconstruction
 - 7.8.2 Steps for Internal Reconstruction
- 7.9 Summary
- 7.10 Exercises
- 7.11 Questions
- 7.12 Suggested Readings

7.0 Objective

By the time you have gone through this unit you would be able to:

- know the meaning of merger and amalgamation, and internal reconstruction;
- understand the types of scheme, its legal aspects and formalities;
- have guidelines for the preparation of different schemes; and
- set in touch with the drafted schemes.

7.1 Introduction

Accountants have to draft different types of schemes. While drafting any scheme in accounting, specialised knowledge, mastery and skill over the subject are required. But the attitude of accountants must differ on the nature of scheme to be drafted because of the differences of intention of different interested groups in the company or companies seeking amalgamation or internal reconstruction. Thus, the principles of drafting a scheme of amalgamation surely differ from the principles of drafting a scheme of internal reconstruction. In the case of a scheme of amalgamation, the objective will be to protect the interests of the shareholders of the amalgamating companies. But in the case of a scheme of internal reconstruction, the objective will be to reorganise the company keeping equity control over the affairs of the company.

In India, during the last decade, a spate of corporate mergers and amalgamations has taken place. With the corporate mergers and amalgamations, Indian corporate scenario is also changing. Keeping this in view, ICAI has issued in October, 1994, AS-14 on 'Accounting for Amalgamations' and made it mandatory for all companies in respect of accounting period commencing on or after 1.4.1995.

7.2 Meaning of Amalgamation and Merger

Traditionally, merger of two or more existing companies under the umbrella of a newly formed company, which takes over the assets and liabilities of existing companies, is called amalgamation. In amalgamation, business of existing companies is liquidated and the shareholders of the liquidated companies become the shareholders of the newly formed company. But modern concept of amalgamation is a broader one. In this concept, the term amalgamation is used when two or more existing companies are involved or when one is merged with another or taken over by another. In practice, amalgamation is a blending of at least two existing undertakings into a single undertaking in which the shareholders of each blending undertaking becomes the shareholders of the blended undertaking.

Merger is another form of amalgamation where the business of at least two combining companies are liquidated and assets and liabilities of the combining companies are transferred to a newly formed company. As a result, the shareholders of the combining companies become the shareholders of combined company.

The objectives of amalgamation or merger are to avoid competition, to derive the benefit of large-scale production, to ensure financial efficacy and to effect managerial efficiency.

7.3 Accounting for Amalgamation

AS-14 mainly deals with the following:

- (a) Accounting for merger where there is a genuine pooling not merely of the assets and liabilities of the amalgamating companies but also of the shareholders' interests and of the businesses of these companies;
- (b) Accounting for acquisition or purchase where one company is acquiring another company and as a consequence the shareholders of the company which is acquired normally do not continue to have a proportionate share in the equity of the combined company or the business of the company which is acquired is not intended to be continued; and
- (c) Disclosures in connection with (a) and (b).

The Standard defines the following terms:

- (a) Amalgamation means an amalgamation pursuant to the provisions of the Companies Act, 1956 or any other statute, which may be applicable to companies.
- (b) Transferor Company means the company, which is amalgamated into another company.
- (c) Transferee Company means the company into which a transferor company is amalgamated.
- (d) Reserve means the portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by the management for a general or a specific purpose other than a provision for depreciation or diminution in the value of assets or for a known liability.
- (e) Consideration for the amalgamation means the aggregate of the shares and other securities issued and the payment made in the form of cash or other assets by the transferee company to the shareholders of Transferor Company.

One has to remember that only payment to shareholders shall be taken into purchase consideration; but payment to debenture-holders and liquidation expenses of the vendor company paid by purchasing company shall not be included in the purchase consideration.

(f) Fair value is the amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.

7.4 Types of Amalgamation

The Standard recognises following two types of amalgamation:

7.4.1 Amalgamation in the nature of merger

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

- (a) All the assets and liabilities of the transferor company become, after amalgamation, the assets and liabilities of the transferee company.
- (b) Shareholders of not less than 90% of the face value of the equity shares of the transferor company (other than equity shares already held therein, immediately before the amalgamation, by the transferee company or its subsidiaries or their nominees) become equity shareholders of the transferee company by virtue of the amalgamation.
- (c) The transferee company discharges the consideration for the amalgamation receivable, by those equity shareholders of the transferor company who agree to become equity shareholders of the transferee company, wholly by the issue of equity shares in the transferee company, except that cash may be paid in respect of any fractional shares.
- (d) The business of the transferor company is intended to be carried on, after amalgamation, by the transferee company.
- (e) No adjustment is intended to be made to the book values of the assets and liabilities of the transferor company when they are incorporated in the financial statements of the transferee company except to ensure uniformity of accounting policies.

7.4.2 Amalgamation in the nature of purchase

'Amalgamation in the nature of purchase' is an amalgamation which does not satisfy any one or more of the conditions mentioned in section 7.4.1.

7.5 Methods of Accounting

The Standard recognises the following two methods of accounting for amalgamation:

7.5.1 Pooling of Interests Method

This method is applicable for amalgamation in the nature of merger of companies operating in the same line of business activities. Under this method, all assets, liabilities and reserves of the transferor company are recorded by the transferor company at their existing carrying amounts with suitable adjustments. In case of conflict in accounting policies of the

two companies, a uniform set of accounting policies is adopted following the amalgamation. In the Standard, some conditions have been laid down that should be satisfied before a company is allowed to adopt 'pooling of interests method' for accounting for amalgamation. The Standard, however, does not allow accounting for goodwill as a result of amalgamation in the books of the transferee company.

7.5.2 Purchase Method

This method is used in accounting for amalgamation in the nature of purchase. The object of this method is to account for the amalgamation by applying the same principles as are used in the usual purchase of assets. The important aspects/points of this method are as follows:

- (a) The transferee company accounts for the amalgamation either by incorporating the assets and liabilities at their existing carrying amounts or by allocating the consideration to individual identifiable assets and liabilities of the transferor company on the basis of their fair values on the date of amalgamation. The identifiable assets and liabilities may include assets and liabilities not recorded in the financial statements of the transferor company.
- (b) The reserves of the transferor company, other than statutory reserves, are not incorporated in the books of the transferee company.
- (c) The excess of purchase consideration over the net assets acquired from the transferor company should be recognised as goodwill and should be debited to Goodwill Account. The goodwill so arising will be amortised over a period not exceeding 5 years unless somewhat loner period can be justified.
 - On the contrary, the excess of net assets acquired over the purchase consideration should be considered as capital profit and should be credited to Capital Reserve Account.
- (d) Statutory Reserves, viz., Development Allowance Reserve, Investment Allowance Reserve, etc. of the transferor company must retain their identity in the financial statements of the transferee company in the same form in which they appear in the financial statements of the transferor company through the following journal entry:

Amalgamation Adjustment Account Dr.

To Individual Statutory Reserve Account

The Amalgamation Adjustment Account will be shown in the Balance Sheet of the transferee company under the head 'Miscellaneous Expenditure'. When the identity of the statutory reserve is no longer required to be maintained, the above mentioned journal entry will be reversed.

7.6 Schemes for Mergers and Amalgamations

The broad lines in which decisions about the modalities, terms and conditions by which the business of at least two companies may come under the umbrella of a newly formed company is known as scheme of amalgamation or merger. In view of implementing the scheme of amalgamation or merger, it is mandatory to get the consent of all the interested parties and also to get the approval of the Court.

7.7 Outlines for Amalgamation Scheme

In order to draft the scheme of amalgamation in the nature of purchase, the following aspects should be carefully looked into:

- (a) All assets including goodwill and liabilities of both the transferor company and the transferee company should be valued for the purpose of valuation of shares.
- (b) Instead of taking full value of goodwill, differential goodwill may be taken in determining the vale of shares.
- (c) A convenient exchange ratio of shares is to be ascertained.
- (d) Some cash payment may be made in order to avoid fractional value of shares.
- (e) Provision for liquidation expenses of the two or more companies to be amalgamated should be made. Again, provision for formation expenses should be made. In the case of insufficiency of cash in the hands of amalgamated company, arrangement of cash should be made with bank or shares may be sold to the promoters or people for cash.
- (f) In order to minimise the expenses of liquidation and to avoid the expenses of formation of a new company, merger of one company with another is preferable.
- (g) Authorised capital may be maintained at lower level in order to avoid high registration fees and filing fees on account of issue of shares at a premium.

Problem 1:

A Ltd. is a public company having a paid up share capital of Rs. 10 lakh consisting of 1,00,000 equity shares of Rs. 10 each. Its net-worth as per last Balance Sheet as on 31.3.2005 is Rs. 15 lakh. The fixed assets of this company, the book value of which is Rs. 5 lakh, have a market value of Rs. 10 lakh. It was declaring dividend @ 10% p.a. for the last 3 years.

B Ltd. is a public company having a paid up share capital of Rs. 1 crore consisting of 1,00,000 shares of Rs. 100 each. Its net-worth as per last Balance Sheet as on 31.3.2005 is Rs. 5 crore. Fixed assets of this company, the book value of which is Rs. 1.50 crore, have a market value of Rs. 2.50 crore. It was declaring dividend @ 20% p.a. for the last 3 years.

The management of both the companies have agreed that A Ltd. should merge with B Ltd. Draft a scheme of merger (in the nature of purchase) of A Ltd. with B Ltd.

Solution

Sub : Scheme of merger of A Ltd. with B Ltd.

Dear Sirs.

As requested, we have the pleasure in submitting hereunder the scheme of merger of A Ltd. with B Ltd. for your consideration :

I. Valuation of Shares:

NOW ARE LOSS TO THE RESIDENCE OF THE PROPERTY	A Ltd.	B Ltd.
	Rs.	Rs.
A. Assets-backing value:		
(a) Net-worth:	and the same of	ON BEAUTY
As per last balance sheet	1,50,000	5,00,00,000
Add: Increase in fixed assets	5,00,000	1,00,00,000
	20,00,000	6,00,00,000
(b) Number of paid up shares	1,00,000	1,00,000
(c) Value per share [(a)/(b)]	Rs. 20	Rs. 600
B. Yield value :		
(a) Company rate of dividend	10%	20%
(b) Market rate of dividend (assumed)	10%	10%
(c) Paid up value per share	Rs. 10	Rs. 100
(d) Value per share [{(a)/(b)} × (c)]	Rs. 10	Rs. 200
C. Fair value per share :	Tank	Ralaming II
[(Asset-backing value) + (Yield value)]/2]	Rs. 15	Rs. 400

II. Exchange Ratio:

Let fair value per share of A Ltd. is A and that of B Ltd. is B.

Now, exchange ratio is

A : B = 15 : 400 or, A/B = (15)/(400) or, 400A = 15B or, 80A = 3B

Therefore, B Ltd. will issue 3 shares for every 80 shares in A Ltd.

Total number of shares to be issued by B Ltd. to A Ltd. is $[(1,00,000) \times 3/(80)] = 3,750$

- III. Purchase Consideration, Capital Reserve and Revaluation Reserve:
- (a) Purchase consideration at nominal value is Rs.100 × 3,750 = Rs.3,75,000
- (b) Capital Reserve on merger is as follows:

(i) Net assets acquired from A Ltd. at market value	Rs. 20,00,000
(ii) Issue of shares at nominal value	Rs. 3,75,000

(iii) Capital reserve on liquidation [(i)-(ii)] Rs. 16,25,000

(c) Revaluation Reserve of B Ltd. is as follows:

(i)	Market value of fixed assets	Rs. 2,50,00,000
(ii)	Book value of fixed assets	Rs. 1,50,00,000
100	Programme Company of the Company of	

(iii) Revaluation reserve [(i)-(ii)]

Rs. 1,00,00,000

IV. If our scheme is accepted, the proposed Balance Sheet of B Ltd. will be:

Before preparation of the proposed Balance Sheet of B Ltd. (after merger), it is required to prepare a summary of Balance Sheets of both the companies as on March 31, 2005 in order to find out the missing figures.

Balance Sheets as on March 31, 2005

(Rs. in lakh)

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Net-worth : Share Capital General Reserve	Rs. 10.000 5.00		Fixed Assets Net Currrent Assets (Balancing figure)	Rs. 5.00 10.00	Rs. 150.00 350.00
(Balancing figure)	15.00	600,00		15.00	500.00

Now, the proposed Balance Sheet of B Ltd. is presented as below:

Balance Sheet of B Ltd. as on March 31, 2005 (after merger of A Ltd.)

(Rs.in lakh)

Liabilities	Amount	Assets	Amount
Share Capital			
Authorised:	to a laboratoria	Fixed Assets (as per valuation	
Shares of Rs.100 each	?	B Ltd. 250.0	0
Issued and Subscribed:		A Ltd. 10.0	260.00
1,03,750 Shares of Rs.100 each	103.75	and the soft least of a management of	T a Thin
Reserves and Surplus		New Current Assets	
Capital Reserve	16.25	B Ltd. 350.0	00
Revaluation Reserve*	100.00	A Ltd. 10.0	360.00
General Reserve	400.00		
	620.00		620,00

^{*} Revaluation Reserve has been created in accordance with AS-17: Accounting for amalgamations.

We shall be glad to furnish you with any further information as you may require.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants

Problem 2:

X Ltd. and Y Ltd. propose to amalgamate. Their Balance Sheets as on March 31, 2005 were (Rs. in thousand):

Liabilities	X Ltd.	Y Ltd.	Assets	X Ltd.	Y Ltd.
Equity Share Capital (Rs.10 each)	600.00	200.00	Fixed Assets less dep. Investments:	495.00	150.00
General Reserve	270.00	47.50	4% Tax Free Bonds	10000	
Profit & Loss A/c	90.00	34.50	(F.V. Rs. 1,20,000)	108.00	-
Creditors	157.75	36.75	Stock-in-trade	240.00	60.75
			Debtors	140.25	75.00
			Cash at Bank	133.50	33.00
	1116.75	318.75		1116.75	318.75

Shapped as become at the U.S.	X Ltd. (Rs.)	Y Ltd. (Rs.)
Net profit after taxation:		
For the year ended 31.3.2003	1,48,500	40,500
For the year ended 31.3.2004	1,64,250	47,100
For the year ended 31.3.2005	1,84,500	62,250

Goodwill may be valued at 4 years' purchase of average super profit from trading on the basis of 10% normal trading profit on closing capital employed. Z Ltd. is formed for the purpose of amalgamation of both the companies.

Advise upon capitalisation of Z Ltd. and suggest a scheme of exchange of shares for that purpose (consider only break-up value). Also draft the Balance Sheet of Z Ltd.

Solution

The Board of Directors

Chartered Accountants

Kalyani-741 235

Kolkata-700 001

Date: April 28,2005

Sub: Scheme of Amalgamation of X Ltd. and Y Ltd. Dear Sirs,

As requested, we have the pleasure in submitting a scheme of amalgamation hereunder for your consideration :

1. Valuation of Shares including Goodwill:

While formulating the scheme of amalgamation X Ltd. and Y Ltd., importance is to be given to evaluate the special advantage attached to the companies. In other words, value of goodwill of the companies is to be determined. This will determine the shareholders' equity and the amount they can claim in the new amalgamated company. The valuation of goodwill is as follows:

(i) Closing Trading Capital Employed:

		A PATA	X Ltd.	Y Ltd.
MUST THE STATE	TOTAL TOTAL SERVICE		Rs.	Rs.
Fixed Assets		ethania :	4,95,000	1,50,000
Stock-in-trade		NETT :	2,40,000	60,750
Debtors			1,40,250	75,000
Cash at Bank	I die maken eine e		1,33,500	33,500
			10,08,750	3,18,750
Less : Creditors			1,57,750	36,750
			8,52,000	2,82,000

(ii) Average Maintainable Profits:

Since the profits have shown an upward trend, it would be appropriate to use weighted average method for determining average profits. This is calculated as below:

Weighted Average Profits

Year		X Ltd			Y Ltd.		
	Profits	Weights	Product	Profits	Weights	Product	
	Rs.	Rs.	Rs.	Rs.			
2002-03	1,48,500	1	1,48,500	40,500	1	40,500	
2003-04	1,64,250	2	3,28,500	47,100	2	94,200	
2004-05	1,84,500	3	5,53,500	62,250	/ ha 3	1,86,750	
		6	10,30,500		6	3,21,450	

THE PARTY OF LABOUR ASSESSED.	Rs.	Rs.
Weighted average profits:		
X Ltd. [(10,30,500)/6]	1,71,750	
Y Ltd.[(3,21,450)/6]	To some little and the	53,575
Less: Income from investments		
@ 4% on Rs.1,20,000	4,800	
	1,66,950	53,575
Y Ltd.[(3,21,450)/6] Less: Income from investments	4,800	ar souds

(iii) Super Profits and Value of Goodwill:

	X Ltd. (Rs.)	Y Ltd. (Rs.)
Average maintainable profits	1,66,950	53,575
Less: Normal return @ 10% on closing trading		
capital Employed	85,200	28,200
Super profits	81,750	25,375
Goodwill at 4 years' purchase of super profits	3,27,000	1,01,500

(iv) Valuation of Shares:

BOS ELECTRON BUILDING BUILDING	X Ltd. (Rs.)	Y Ltd. (Rs.)
Closing trading capital employed	8,52,000	2,82,000
Add: Goodwill	3,27,000	1,01,500
4% Tax Free Bonds	1,08,000	
Net assets for shareholders (i)	12,87,000	3,83,500
Number of shares (ii)	60,000	20,000
Value per share [(i)/(ii)]	Rs. 21.45	Rs. 19,175

II. Exchange Ratio of Shares, Number of Shares to be issued and Cash Requirement:

It is difficult to find out a suitable exchange ratio of shares having regard to the value of shares arrived at. It would be better to make some cash payment (as there is sufficient cash at bank) in order to find out a convenient exchange ratio. This can be achieved as follows:

The value of 10 shares of X Ltd. is Rs. $21.45 \times 10 = \text{Rs.} 214.50$

The value of 10 shares of Y Ltd. is Rs. $19.175 \times 10 = \text{Rs.} 191.75$

Therefore, Z Ltd. will make payment to the shareholders of vendor companies as follows:

- Z Ltd. will issue 21 shares of Rs.10 each and pay Rs.4.50 in cash for every 10 shares in X Ltd.
- (2) Z Ltd. will issue 19 shares of Rs.10 each and pay Rs.1.75 in cash for every 10 shares in Y Ltd.

As a result, the total number of shares to be issued by Z Ltd. will be as follows:

(1) Shareholders of X Ltd. [(60,000) × (21)/(10)]	1,26,000 shares
(2) Shareholders of Y Ltd. [(20,000) × (19)/(10)]	38,000 shares
	1,64,000 shares
Requirement of cash of Z Ltd. will be as follows:	Rs.
To pay shareholders of X Ltd. $[(60,000)/(10) \times Rs.4.50]$	27,000
To pay shareholders of Y Ltd. [(20,000)/(10) × Rs.1.75]	3,500
Liquidation expenses of X Ltd. (say)	4,000
Liquidation expenses of Y Ltd. (say)	4,000
Expenses of formation of Z Ltd. (say)	6,500
	45,000

III. If our scheme is accepted, the Balance Sheet of Z Ltd. will be:
Balance Sheet of Z Ltd. as on March 31, 2005

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital		Fixed Assets	de Oude
Authorised:		Goodwill (3,27,000 + 1,01,500)	
shares of Rs.10 each	?	+ 4,000 + 4,000)	4,36,500
		Other Fixed Assets	
		(4,95,000 + 1,50,000)	6,45,000
Issued and Subscribed:	6	Investments	
1,64,000 shares of Rs.10 each	16,40,000	4% Tax Free Bonds	
Current Liabilities and		(Face Value Rs. 1,20,000)	1,08,000
Provisions		Current Assets, Loans and	
Creditors (1,56,750 + 36,750)	1,93,500	Advances	
		Stock-in-trade	3,00,750
	an a pai	(2,40,000 + 60,750)	
		Debtors (1,40,250 + 75,000)	2,15,250
		Cash at Bank	1,21,500
		(1,33,500 + 33,000 - 45,000)	
		Miscellaneous Expenditure	
		Perliminary Expenses	6,500
	18,33,500		18,33,500

We shall be glad to furnish you with any further information that you may require.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants

Problem 3: Following are the Balance Sheets of P Ltd. and Q Ltd. as on March 31, 2005:

Liabilities	P Ltd.	Q Ltd.	Assets	P Ltd.	Q Ltd.
	Rs.	Rs.		Rs.	Rs.
Share Capital					
Equity Shares of	7736		Fixed Assets	7,60,000	3,80,000
Rs.10 each	10,00,000	2,00,000			
6% Pref. Shares	so more	in two trees	Current Assets,	mos tribus	
of Rs.10 each	-	2,00,000	Loans & Advances		
Secured Loans	MURREY DO		Stock .	2,00,000	1,00,000
9% Debenture of	170.0c.15		Debtors	3,00,000	1,50,000
Rs.100 each	_	1,00,000	Cash and Bank	60,000	30,000
Reserves & Surplus					
General Reserve	1,00,000	50,000	Dischart Hara Old	Ella South	00001051
Profit & Loss A/c	1,70,000	85,000		residence.	History 1
Current Liabilities				*	
and Provisions	Ne may be	JEN AND S			
Creditors	50,000	25,000		HARD SEL	Eligi Ribini 2
Denta	13,20,000	6,60,000		13,20,000	6,60,000

Profit and Loss Account balances were made up as follows:

	P Ltd.	Q Ltd.
	Rs.	Rs.
Balance on 1.4.2004	20,000	10,000
Add: Profit for the year before interest on debentures	1,50,000	75,000
	1,70,000	85,000

Negotiations are going on for merger of Q Ltd. with P Ltd. Suggest a suitable scheme. Ignore corporate tax.

Solution

X & Co. The Board of Directors

Chartered Accountants Kolkata-700 039 Durgapur-713 214

Date: April 29, 2005

Sub: Scheme of Merger of Q Ltd. with P Ltd.

Dear Sirs,

As requested, we have the pleasure in submitting a scheme of merger of Q Ltd. with P Ltd. for your consideration in the following lines:

I. Valuation of Goodwill with Leverage Effect:

It is clear from the Balance Sheets of both the companies that Q Ltd. is exactly half the P Ltd. in all respects except the composition of capital structure. Again, profit earned before debenture interest and preference dividend is also half in the case of Q Ltd. in comparison with P Ltd. The difference in the composition of capital structure makes a significant difference as regards yield to equity shareholders. In other words, the effect of leverage is to be taken into consideration in valuing goodwill. This aspect is covered in the scheme as below:

(i) Expected yield to Equity Shareholders:

	P Ltd. (Rs.)	Q Ltd. (Rs.)
(a) Profit before debenture interest and preference		DULK
dividend for the year ended 31.3.2005	1,50,000	75,000
(b) Debenture interest and preference dividend		21,000
(c) Profit available for equity dividend [(a)—(b)]	1,50,000	54,000
(d) Paid up equity share capital	10,00,000	2,00,000
(e) Expected rate of yield [(c) x (100)/(d)]	15.00%	27.00%

(ii) Valuation of Goodwill:

Market value of equity shares is highly dependent on the expected yield or dividend paid. It is obvious from the rate of yield that Q Ltd. has almost double the ability to pay dividend to its equity shareholders in comparison with P Ltd. although its profit before interest and preference dividend is half of P Ltd. This advantage unless compensated to the shareholders of Q Ltd., they will not agree to any proposal for merger. The exact valuation of this advantage depends on the normal expectation on equity capital. Assuming the normal expectation on equity capital is 15%, keeping the equity shareholders of P Ltd. at par. The valuation of this advantage, i.e., goodwill of Q Ltd. is calculated as follows:

(a) Profit after debenture interest and preference dividend,	
i.e., profit available for equity dividend	Rs. 54,000
(b) Normal return on equity capital at 15% on Rs. 2,00,000	Rs. 30,000
(c) Super profit [(a)—(b)]	Rs. 24,000
(d) Value of goodwill on the basis of capitalisation of super	
profit at 15% [(c)/15%]	Rs. 1,60,000

II. Valuation of Equity Shares (Asset-backing value):

nwise ridge executivened a kandinalis in a second	P Ltd.	Q Ltd.
	Rs.	Rs.
(a) Net assets for equity shareholders:	S PUNDU S PUN	
Equity Share Capital	10,00,000	2,00,000
General Reserve	1,00,000	50,000
P&L A/c after debenture interest and pref. dividend	1,70,000	64,000
Goodwill		1,60,000
to least their Mark Center III as his benefit there is Alita City	12,70,000	4,74,000
(b) Number of equity shares	1,00,000	20,000
(c) Value per share [(a)/(b)]	Rs. 12.70	Rs. 23.70

III. Exchange Ratio of Equity Shares, Purchase Consideration, Number of Shares to be issued, Cash requirement, etc:

Considering the value of shares, it is difficult to find out the exchange ratio. With a view to finding out a convenient exchange ratio, some cash payment may be made in order to avoid fraction. This is done as follows:

The value of 13 shares of P Ltd. is Rs.12,70 \times 13 = Rs.165.10

The value of 7 shares of Q Ltd. is Rs.23.70 \times 7 = Rs.165.90

Thus, for every 7 shares in Q Ltd., P Ltd. will issue 13 shares of Rs.10 each at a premium of Rs.2.70 per share and pay Re.0.80 in cash.

Total number of equity shares to be issued to Q Ltd.:

- (a) Divisible value of 7 shares against 20,000 shares of Q Ltd. is 2,857, [i.e., (20,000)/7 = 2,857.14 28 or, 2,857]
- (b) Number of shares to be issued by P Ltd. to equity shareholders of Q Ltd is 37,141 shares (i.e., $2,857 \times 13 = 37,141$).

Total number of equity shares of P Ltd. for Balance Sheet purpose is as follows:

- (a) Existing number of shares is 1,00,000
- (b) Number of shares to be issued to Q Ltd. is $2,857 \times 13 = 37,141$
- (c) Total number of shares [(a) + (b)] is 1,37,141

Payment of Purchase Consideration to Q Ltd. is as follows:

	Rs.	
(a) Issue of 37,141 equity shares of Rs.10 each at a	Superior Chicago	
premium of Rs.2.70 per share 37,141 × 12.70	4,71,691 (approx.)	
(b) Cash payment for divisible shares [0.80 × 2,857]	2,285 (approx.)	
(c) Cash payment for fractional value of shares		
$(0.1428 \times 7 \times 23.70)$	24 (approx.)	
(d) Total payment [(a) + (b) + (c)]	4,74,000	
Total cash requirement for payment is as follows:		
	Rs.	
(a) To equity shareholders of Q Ltd. (2,285 + 24)	2,309	
(b) Liquidation expenses of Q Ltd. (say)	5,000	
(c) Total cash payment to Q Ltd. [(a) + (b)]	7,309	

In addition, the debenture-holders in Q Ltd. should receive debentures in P Ltd. of the same amount. Similarly, the preference shareholders in Q Ltd. should receive preference shares in P Ltd of the same amount. Presumably both the debenture-holders and preference shareholders of Q Ltd. may not have any objection to the merger with P Ltd. since their funds will be even more safe and secured in P Ltd.

V. If the scheme of merger of Q Ltd. with P Ltd. is carried on, the Balance Sheet of P Ltd. will be as follows:

Balance Sheet of P Ltd. as on March 31, 2005

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital	SE MAIN	Fixed Assets	W.
Authorises :		Goodwill 1,60,000	
Equity Shares of Rs.10 each	7	Add : Liquidation	
6% Preference Shares of	Lavri de de	expenses paid 5,000	1,65,000
Rs,10 each	?	Other Fixed Assets	
	?	(7,60,000 + 3,80,000)	11,40,000
Issued and Subscribed:	on the	Current Assets, Louns and	in the
1,37,141 Equity Shares	be business	Advances	and more
of Rs.10 each	13,71,410	Stock (2,00,000 + 1,00,000)	3,00,300

Liabilities	Amount	Assets Assets	Amount
	Rs.		Rs.
20,000 6% Preference	and the state of t	Debtors (3,00,000 + 1,50,000)	4,50,000
Shares of Rs.10 each	2,00,000	Cash & Bank	
Reserves & Surplus		(60,000 + 30,000) 90,000	
Securities Premium	1,00,281	Less : Cash payment7,309	82,691
(Rs. 2.70 × 37,141)	. Frank	o bule a source state and an automore	(a) Line
General Reserve	1,00,000	10 TEAT TO 数数	01.
Profit & Loss A/c	1,70,000	- Stay - (d) if (d) I throwing Iv	s 7 des
Secured Loans	200	di regilegravati torgin on phia a	in the last
10% Debentures	1,00,000		747
Current Liabilities and	11200		
Provisions		Double the other dends things	ALL THE
Creditors (50,000 + 25,000)	75,000	your units to company her have	of i tell
Debenture Interest Due	9,000	Federa proposed to D. Ed. Rais	hit bin
Pref. Dividend Due	12,000	The solder received and all	uilheet a
	21,37,691	man de la compania del compania del compania de la compania del compania de la compania de la compania del compania de la compania del	21,37,691

We shall be obliged to furnish you with any further clarification and information that you may require in this connection.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants

7.8 Scheme of Internal Reconstruction

The need for reconstruction arises when a company has accumulated huge losses or when a company finds itself over-capitalised, which means either that the value placed on assets is very high compared to their carning capacity or that the profits generated by the company is not sufficient to pay a proper dividend. Considering these aspects, a company is required to be reorganised to inject fresh blood to save the company from its unwanted liquidation. In order to reorganise a company, the Board of Directors place a scheme before all the interested parties for their consent and get it approved by the Court for its implementation. When this is done without altering the name of the existing company, it is

known as internal reconstruction. In other words, implementation of a scheme after it is consented to by all the interested parties, viz., shareholders, debenture-holders, creditors, etc., having the approval of the Court with a view to bringing equilibrium between assets and liabilities for better future without liquidation and change in the name of the existing company is known as scheme of internal reconstruction.

7.8.1 Circumstances of Internal Reconstruction

Internal reconstruction is advisable or preferable under the circumstances noted below:

- (1) The present position of the company is bad but good days are ahead.
- (2) The shareholders, debenture-holders and creditors, specifically bankers have not only agreed to sacrifice but are also ready to subscribe to further capital.
- (3) The company is interested to carry forward its past losses or is interested to get the benefit of set off of past losses against future profits. This will ultimately minimise the tax burden for a few years.
- (4) The proposal for internal construction is consented to by all the interested groups of the company without any delaying tactics such as legal objections and dissensions.
- (5) The company is not willing to lose its present legal entity or the company is likely to have a fresh chance of avoiding liquidation.

7.8.2 Steps for Internal Reconstruction

The fundamental basis of any reconstruction proposal is the earning capacity of the company. Even the payment of debenture interest is not possible unless the activities of the company are profitable. A very careful estimate should, therefore, be made as to the future anticipated profits of the company. Unless profits are sufficient to meet all expenses including adequate depreciation, interest on borrowed capital, preference dividend and a reasonable return on equity capital, reconstruction would be useless because the need for another reconstruction will arise soon again. Thus, internal reconstruction should be made very carefully because when a company is once reconstructed, it must survive potentially for an indefinite long period. The essence of internal reconstruction is that the reconstructed company has the potentiality to generate sufficient profits in future.

The equity shareholders will have to bear a higher proportion of losses because they are the real owners of the company. In course of distribution of losses to be written off among the various interested groups of the company, the control over the affairs of the company by the equity shareholders must not be overlooked.

The requirement of working capital should not be ignored. Cash may be required to pay off some dissenting creditors or even to pay arrear preference dividend. The willingness by the shareholders, debenture-holders, etc. to provide required cash fund is, thus, a basic requirement for the success of a reconstruction scheme.

In order to implement the scheme of internal reconstruction, the following steps may be advocated:

(1) Estimation of total loss:

This is the first step in estimating total loss to be written off for drafting a scheme of internal reconstruction. The total loss is estimated on the basis of the latest Balance Sheet and other information of the company. Total loss may be ascertained as follows:

Statement of Estimated Total Loss

to a company is volucested to carry fire an insular lossos of a service and	Rs.
Fictitious Assets like debit balance in the profit and loss account,	xxx
preliminary expenses, discount on issue of shares and debentures,	
underwriting commission, reconstruction expenses, etc.	ххх
Add: Intangible Assets like goodwill, patents and trade marks to the	
extent they lost their values.	×××
Contingent liabilities like cumulative arrear preference dividend, etc.	
是自己的一种,我们就是一个一个一个一个一个一个一个一个一个一个一个一个一个一个一个一个一个一个一个	xxx
Loss on revaluation of assets and liabilities	×××
Less : Profit on revaluation of assets and liabilities	xxx
Net loss to be written off	ххх

(2) Estimation of realisable value of assets(in case of forced liquidation) and its likely distribution:

Estimated realisable value of assets can be obtained by summing up all assets after valuation on the basis of forced sales (or, going concern value basis). Likely distribution of assets may be shown as follows:

ar anglan	openadi not o beprenados) iligida topor a c	Rs.	Rs.
Estimated realisable value of all assets		and without and and and	xxx
Lees:	Preferential Creditors:	discontilled but you	prodit .
	Tax liability	min and the exxx	Mr all Pi
	Workers' dues	xxx	xxx

negatives (uniformity of order as no data of care in this a state law, unifor	Rs.	Rs.
Surplus assets available for secured creditors, unsecured	Caro troops	
creditors and shareholders	Delatery in	xxx
Less : Secured Creditors :		
Debenture-holders (secured against assets)	xxx	
Other secured creditors	xxx	xxx
Surplus assets available for unsecured creditors and shareholders	19. BB 19	×××
Less: Unsecured Creditors:	With Edition	
Trade creditors, bills payables, etc.	xxx	×××
Surplus/Deficiency for shareholders	11	xxx
Less : Preference Shareholders' Claim :	Same and	
Preference share capital	×××	
Arrear preference dividend	×××	×××
Surplus/Deficiency as regards Preference Shareholders	In Fac	×××
Less : Equity share capital		xxx
Deficiency as regards equity shareholders		×××

(3) Writing off loss:

This is a very crucial aspect of the scheme of internal reconstruction. If preferential creditors, secured creditors (i.e., debenture-holders) and unsecured creditors are fully covered by the realisable value of assets, naturally they will not bear any loss. They are affected only if the realisable value of assets is insufficient to cover even their liabilities. In such an eventuality, they will have to make sacrifice. The order of their sacrifice will be (a) preferential creditors (no sacrifice), (b) secured creditors (sacrifice depending on the value of securities), and (c) unsecured creditors (heaviest sacrifice). The same principle is applicable to preference shareholders as to refund of their capital. They may be persuaded to share loss in a situation when the refund of preference capital is uncertain by the availability or otherwise of the realisable value of assets after its likely distribution to preferential creditors, secured creditors and unsecured creditors. In that situation, they will naturally forego arrear preference dividend and bear loss, which will be relatively higher than that of the creditors. But the sharing of loss by the preference shareholders will be much lower than that of the equity shareholders.

(4) Compensation to debenture-holders, other creditors and preference shareholders for bearing loss:

The debenture-holders may be compensated by means of increase in the rate of interest in such a manner so that their total earnings on account of interest will remain the same as before. The same principle may be applied to preference shareholders. In case

of need, non-participating preference shares may be converted into participating preference shares without disturbing the control of equity shares over the affairs of the company or, participating preference shares may be converted into equity shares if the existing control of the equity shares is not changed. Payment of arrears of dividend to cumulative preference shareholders in cash may immediately invite difficulties. In such a case, a good method is to issue deposit certificates to them to avoid immediate burden on liquid resources. But arrears of dividend on non-cumulative preference shares are usually cancelled. As a part of compensation, some portion of unsecured creditors may be paid in cash through the arrangement of liquid funds.

(5) Arrangement of working capital:

Working capital is the life-blood of the business. Therefore it is necessary that the reconstructed company should have adequate working capital at its disposal. It can be raised by further call on existing reduced shares, sale of investments, issuance of new debentures and shares, arrangement of overdraft and the like.

(6) Estimation and disposal of expected future profits :

This is the last step but not the least in importance in the scheme of internal reconstruction. Under this section, due care should be given in estimating future profits and its disposal so that return on equity capital is fair.

Problem 4:

The following is the Balance Sheet of Unfortunate Ltd. as on March 31, 2005:

Liabilities	Amount	Assets	Amount
ดูโดย - มีโดย เชียงให้ หลุดเกาะเคย่าสัย	Rs.	masterial southers on teres	Rs.
Share Capital:		Goodwill	1,80,000
60,000 Equity Shares of	WHIST BEST	Plant & Machinery	5,40,000
Rs. 10 each	6,00,000	Stock	1,74,000
1,200 6% Cumulative Pref.		Debtors	1,20,000
Shares of Rs.100 each	1,20,000	Cash at Bank	6,000
Sundry Liabilities	6,00,000	Profit & Loss A/c	3,00,000
	13,20,000	A LICENSE AND BOT OFFICE	13,20,000

Preference share dividends are 3 years in arrear. Draft a suitable scheme of internal reconstruction, which would help the company to reorganise in the following lines:

- (a) To write off the profit and loss account and goodwill.
- (b) To depreciate plant and machinery by 10%.
- (c) To satisfy the arrears of preference dividends.
- (d) To provide Rs.60,000 as liquid resources.

Solution

The Board of Directors
Unfortunate Ltd.
Kolkata-700 012

Y & Co.

Chartered Accountants

Kolkata-700 001

Date: April 30, 2005

Ref: Scheme of Internal Reconstruction of Unfortunate Ltd.

Dear Sirs,

With reference to your letter dated 7.4.2005, we are submitting the scheme of internal reconstruction hereunder:

(1) Total loss to be written off:

	Rs.
Debit balance in the profit and loss account	3,00,000
Goodwill	1,80,000
Depreciation on pant and machinery (5,40,000 × 10%)	54,000
Arrear preference dividends (1,20,000 × 6% × 3)	21,600
	5,55,600

(2) Estimated realisable value of assets (in case of forced liquidation) and its likely distribution:

	Rs.	Rs.
Realisable value of assets:	THE REAL	
Plant and Machinery (5,40,000 × 90%)	4,86,000	
Stock	1,74,000	
Debtors	1,20,000	
Cash at Bank	6,000	7,86,000
Less: Unsecured Creditors (Sundry Liabilities)		6,00,000
Surplus available for Shareholders		1,86,000
Less: Preference Shareholders' Claim;		
6% Preference Share Capital	1,20,000	
Arrear preference dividend	21,600	1,41,600
Surplus available for Equity Shareholders		44,400
Less : Equity Share Capital	To Back	6,00,000
Deficiency as regards Equity Shareholders	THE REPORT OF	5,55,600

(3) Writing of Loss:

In the context of the above relative position in liquidation, loss to be written off should be shared as below:

- (a) Sundry Liabilities: Since their claim is fully covered in case of forced liquidation, naturally they will not sacrifice anything.
- (b) Preference Shareholders: The claim of preference shareholders is also fully covered even if forced liquidation takes place. But in order to smoothen implementation of the scheme, equity shareholders cannot be asked to sacrifice more than 90% of their claim, i.e., Rs. 9 per share. In this situation, preference shareholders will be asked to sacrifice a bit, only Rs. 15,600 (i.e., Rs. 5,55,600—Rs. 9 × 60,000) which will reduce their value by Rs. 13 [i.e., (Rs. 15,600)/(1,200)] per share. The paid up value after sacrifice will be Rs. 87 (i.e., Rs. 100 Rs. 13) per share. As a part of compensation, the rate of dividend may be increased from 6% to 7.50%.
- (c) Equity Shareholders: In case of forced liquidation, equity shareholders will get very negligible amount considering time and expenses on account of liquidation. In view of maintaining control over the affairs of the company, equity shareholders will be asked to sacrifice a lion's share, Rs. 9 per share (i.e., Rs.10 × 90%). As a result, paid up value will be Re. 1 (i.e., Rs. 10 Rs. 9) per share.

(4) Arrangement of Liquid Funds:

	Rs,	Rs.
Payment of arrears of preference dividend	21,600	
Add: Requirement of liquid resources	60,000	81,600
Less : Cash at Bank		6,000
Additional requirement of liquid resources		75,600

The above amount may be arranged as loan from bank at 10% p. a. by the mortgage of plant and machinery by means of floating charge.

(5) If our scheme is accepted, the Balance Sheet of Unfortunate Ltd. will be as below:

Balance Sheet of Unfortunate Ltd. as on March 31, 2005 (And Reduced)

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital :		Fixed Assets	
Authorised		Plant and Machinery	4,86,000
Equity Shares of	?	Alties etc	
Re.l each		a Welstell White Billy	er an Assumative

Liabilities	Amount	Assets	Amount
Shallid was suit it in	Rs.	latt sulpressed to south assets	Rs.
7.50% Preference Shares		Current Assets	
of Rs.87 each	?	Stock	1,74,000
		Debtors	1,20,000
Issued and Subscribed		Cash at Bank	60,000
60,000 Equity Shares of		unerveries and the second	
Re.1 each	60,000	Find Storman F	
1,200 7.50% Preference		500.00,1	
Shares of Rs.87 each	1,04,400	(Abbre es) esculuir	
Secured Loans		GEORGE Commitment & made for	
Bank Loan on Mortgage 10%	75,600	E Acodemic Company	
Current Liabilities		100 the second second	
Sundry Liabilities	6,00,000	MINISTER STATE OF THE STATE OF	
	8,40,000		8,40,000

(6) Estimation and disposal of expected future profits :

In estimating future expected profits, it is required to ascertain the capital employed. Capital employed after reconstruction of the company will be Rs. 2,40,000, which consists of equity capital, preference capital and loan from bank, (i.e., Rs. 60,000 + Rs. 1,04,400 + Rs. 75,600). The company has to pay no tax for the coming few years because of the tax benefit due to set off of past losses. Therefore, a reasonable rate of return before interest @ 12% on Rs. 2,40,000, capital employed is expected to meet the claims for interest on bank loan, dividends and others as follows:

(i)	For interest on bank loan (75,600 × 10%)	Rs.	7,560
(ii)	For preference dividend $(1,200 \times 87 \times 7.50\%)$	Rs.	7,830
(iii)	For equity dividend (60,000 × 1 × 12%)	Rs.	7,200
(iv)	For transfer to reserve (assumed)	Rs.	5,760
(v)	For balance carried forward in the profit and loss account	Rs.	450
(vi)	Estimated future expected profits $[(i) + (ii) + (iii) + (iv) + (v)]$	Rs.	28,800
We	shall be glad to furnish you with any further information that you	may red	quire.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants

Problem 5:

The Balance Sheet of Progressive Ltd. as on March 31, 2005 is as follows:

Liabilities	Amount	Assets	Amount
ON THE RESERVE OF THE PARTY OF	Rs.		Rs.
15,000 Equity Shares of		Goodwill	50,000
Rs.10 each	1,50,000	Building	90,000
10,000 7% preference Shares		Plant and Machinery	40,000
of Rs.10 each	1,00,000	(Market value is 15% less	TO MAN TO SE
10% Debentures (secured		than book value)	
against plant & machinery)	30,000	Investments (Market value	
Workmen's Accident		Rs. 25,000)	20,000
Compensation Fund	10,000	Stock (Market value	C HIDE
Profit Sharing Fund	10,000	Rs. 12,000)	15,000
Staff Welfare Fund	5,500	Debtors	30,000
Sundry Creditors	41,000	Profit and Loss A/c	1,01,500
	3,46,500		3,46,500

Prepare a Capital Reduction Scheme and redraft the Balance Sheet after incorporating your proposal for submission to the Board of Directors.

The following are certain relevant facts that may be considered in formulating the scheme:

- (a) Estimated liability on account of workmen's accident compensation fund is Rs. 9,000.
- (b) Preference Shares are cumulative and preferential as regards dividend as well as capital. The preference dividends are in arrears for two years.
- (c) The company needs to have liquid resources of Rs. 25,000 for working capital purposes.
- (d) Bad debts are estimated at Rs. 1,500.
- (e) Current year's interest on debenture is outstanding.
- (f) Sundry Creditors include tax liability of Rs. 5,000.

Solution

The Board of Directors Progressive Ltd. Kolkata-700 012 Z & Co.

Chartered Accountants Kolkata-700 001

Date: April 27, 2005

Ref: Scheme of Capital Reduction of Progressive Ltd.

Dear Gentlemen,

With reference to your letter dated 10.04.2005, we have the pleasure in submitting a scheme for capital reduction of your company for your consideration in the following lines:

(1) Total loss to be written off:

DRADE TO THE PROPERTY OF THE P	Rs.	Rs.
Goodwill	50,000	
Profit and Loss A/c	American (1,01,500
Plant and Machinery	STATE OF THE	2,000
Stock	Meson of	3,000
Debtors	and onthe o	5,000
Arrear preference dividend (1,00,000 × 7% × 2)	o alternative	14,000
Outstanding interest on debentures		3,000
		1,78,500
Less: Increase in the value of investments	5,000	
Decrease in workmen's accident compensation fund	1,000	6,000
CONTRACTOR OF THE PROPERTY OF	APARISME.	1,72,500

(2) Estimated realisable value of assets (in case of forced liquidation) and its likely distribution:

	Rs.	Rs.
Building	MER VIEW	90,000
Plant and Machinery (40,000 - 2,000)	By diffici	38,000
Investments	ON THE SU	25,000
Stock		12,000
Debtors (30,000 - 5,000)		25,000
Assets available for distribution	1 /203 411	1,90,000
Less: Preferential Creditors:	Rt. Date Commission	
Tax liability	5,000	
Workmen's accident compensation fund	9,000	14,000
Surplus assets available for secured creditors, unsecured		
creditors and shareholders		1,76,000
Less : Secured Creditors (10% Debenture with interest due)	THE INTERNA	33,000
Surplus assets available for unsecured creditors and	de la companie	
shareholders	A STERRY	1,43,000

	Rs.	Rs.
Less: Unsecured Creditors:	or of ourself	
Staff welfare fund	5,500	
Profit sharing fund	10,000	
Sundry Creditors (41,000 - 5,000)	36,000	51,500
Surplus assets available preference and equity shareholders		91,500
Less: Preference Shareholders Claim:		
7% Preference share capital	1,00,000	
Arrear preference dividend	14,000	1,14,000
Deficiency as regards preference shareholders		22,500
Less : Equity Share Capital		1,50,000
Deficiency as regards equity shareholders	daul sense	1,72,500

(3) Writing off Loss:

In view of the above relative position in liquidation, the loss may be written off as below:

- (a) Preferential Creditors—As they are sufficiently covered, they will not sacrifice anything.
- (b) Secured Creditors (Debenture-holders)—They are also covered. Therefore, they cannot be asked to sacrifice anything.
- (c) Preference and Equity Shareholders—Since the preference shareholders have got the priority as to the return of capital as well as dividend at the time of liquidation, they usually cannot be asked to sacrifice anything. But the available surplus assets are not sufficient to pay their claims in full. Naturally, they may be persuaded to sacrifice something, and the equity shareholders' claim cannot be completely wiped of which means liquidation of the company. In these situations, the equity share value may be reduced to a token value of Re. 1 per share. Therefore, balance of loss of Rs. 37,500 [i.e., Rs. 1,72,500 – (Rs. 1,50,000 – Re. 1 × 15,000)] should be sacrificed by the preference shareholders. As a result, preference shares of Rs. 10 each fully paid will be reduced by Rs. 3.75 [i.e., (Rs. 37,500)/(10,000)] per share.

In view of making compensation to preference shareholders, the rate of dividend may be raised from 7% to 9%.

(4) Arrangement of working capital:

In order to provide Rs. 25,000 for working capital, the company may be advised to sell the investments at the market value rather than collection of liquid fund from borrowings which is now difficult. This will not impose any burden of interest on the operation of the

company for taking loan. For paying arrears of preference dividend, *Deposit Certificates* may be issued in lieu of cash payment. This is preferable because it will not give any voting right and the certificate can be redeemed as soon as opportunity arises.

(5) If the scheme is implemented, the Balance Sheet of Progressive Ltd. will be as follows:

Balance Sheet of Progressive Ltd. as on March 31, 2005 (And Reduced)

Liabilities	Amount	Assets	Amount
	Rs.	THE STATE OF THE PARTY OF THE BUT IN	Rs.
Share Capital:	bus lusar	CITY IN THE ABOUT BUILDING A SHIPPING A	
Authorised:	÷ (40 1 10)	Fixed Assets	of the
Equity Shares of	is the	Building	90,000
Re.1 each	?	Plant and Machinery	38,000
9% Preference Shares		Current Assets, Loans	20,000
of Rs. 6.25 each	?	and Advances	S. S. BARRA
Issued and Subscribed:		Stock (Market value)	12,000
15,000 Equity Shares of		Debtors HEMINA MARIN	25,000
Re. I each	15,000	Cash at Bank	25,000
10,000 9% Preference Shares			25,000
of Rs. 6.25 each	62,500	Fig. spuits contribet united galvio	
Secured Loans		Company In Control American	
10% Debentures	30,000		
Outstanding Debenture interest	3,000		
Unsecured Loans	115 1		
Deposit Certificates	14,000	and the second second	
Current Liabilities and			Service Control
Provisions			
Workmen's Accident	*		
Compensation Fund	9,000		
Profit Sharing Fund	10,000	Indiana de la companya del companya de la companya della companya	
Staff Welfare Fund	5,500	008	
Sundry Creditors	41,000		E Broke B
	1,90,000	literal states	1,90,000

(6) Disposal of expected future profits:

In order to determine the expected future profits, it is required to ascertain the amount of capital employed. The capital employed after reconstruction of the company will be

Rs. 1,07,500 consisting of equity share capital, 9% preference share capital and 10% debentures. Since tax liability will not arise for the coming few years because of the set off of past losses, earnings before interest may be taken to be, at a conservative estimate, at about 12% on capital employed, which will generate Rs. 13,000 per annum. The likely disposal will be:

(i)	For debenture interest (30,000 × 10%)	Rs.	3,000
(ii)	For preference dividend (62,500 × 9%)	Rs.	5,625
(iii)	For transfer to reserve (assumed)	Rs.	2,580
(iv)	For balance carried forward in the profit and loss account	Rs.	1,795
(v)	Estimated future profits before tax [(i) + (ii) + (iii) + (iv)]	Rs.	13,000

We shall be glad to furnish you with any further clarification that you may require.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants

Problem 6:

The following is the Balance Sheet of Paradise India Ltd. as on March 31, 2005:

. Liabilities	Amount	Assets	Amount
	Rs.	THE ASS.	Rs.
Share Capital (fully paid		Goodwill	72,000
shares of Rs.100 each):		Patent Rights	96,000
Equity	2,40,000	(Estimated value Rs. 36,000)	See In the
6% Cumulative preference	3,60,000	Buildings at cost	1,56,000
6% Debentures, secured by a		Plant & Machinery at cost	3,09,600
floating charge on all assets	1,20,000	Stock (Market value)	76,000
Interest due on above	14,400	Debtors (Considered good)	68,000
Sundry Creditors	1,20,000	Profit & Loss A/c	1,05,600
Bank Overdraft	28,800	Entre H	DE WEST
(limit Rs. 30,000)			and refere
	8,83,200		8,83,200

Dividends on preference shares are in arrear for two years. The directors of the company are of the opinion that if an additional plant is installed at a cost of Rs. 1,20,000 and working capital needs are fully met, the company will earn enough profit to pay equity

dividend @ 10% subject to a suitable scheme of internal reconstruction being put through. The existing buildings and plant & machinery are considered being worth Rs. 1,82,400 and Rs. 2,40,000 on a going concern basis.

Debenture-holders are anxious to be paid the interest due to them but are willing to provide half of the additional capital required on suitable basis. Preference shareholders are willing to accept a reasonable sacrifice provided they are given berth in the equity capital.

Suggest a suitable scheme of internal reconstruction.

Solution

The Board of directors Paradise India Ltd. 16, Gokhele Road Kolkata-700 022

T & Co. Chartered Accountants Kalyani-741 235 Date: April 25, 2005

Sub: Internal Reconstruction of your Company

Dear Sirs,

As requested, we have given below our suggestions for a scheme of internal reconstruction for your consideration and for placing them before the different classes of creditors and shareholders.

(1) Accumulated and expected losses to be written off:

Debit balance in the Profit and Loss A/c	Rs.
Goodwill	1,05,600
	72,000
Patent Rights (96,000 - 36,000)	60,000
Plant and Machinery (3,12,000 – 2,40,000)	72,000
Arrear preference dividends (3,60,000 × 6% × 2)	43,200
	3,52,800
Less: Increase in the value of Buildings (1,82,400 - 1,56,000)	26,400
Allega devilation for likelia distribution between preference and a print	3,26,400

(2) Estimated realisation of assets (going concern value basis) and its likely distribution:

Part of Disks	Rs.	Rs.
Patent Rights		36,000
Buildings		1,80,000
Plant and Machinery	dial slong	
Stock	Divini la compa	2,40,000
Stock		76,000

	Rs.	Rs.
Debtors		68,000
Total Assets available for distribution		6,00,000
Less: Creditors having floating charge: 6% Debenture-holders Interest due on above	1,20,000 14,400	
Surplus Assets available for Unsecured Creditors and Shareholders		1,34,400 4,65,600
Less: Unsecured Creditors: Sundry Creditors Bank Overdraft	1,20,000 28,800	1,48,800
Surplus Assets available for Shareholders Less: 6% Cumulative Preference Shareholders Claim:	3,60,000	3,16,800
Preference Share Capital Arrear preference dividends	43,200	4,03,200
Deficiency as regards Preference Shareholders		86,400 2,40,000
Less : Equity Share Capital Deficiency as regards Equity Shareholders		3,26,400

(3) Writing of Loss:

In the context of the above relative position, the loss of Rs.3,26,400 is suggested to be shared by different interested groups as below:

- (a) Creditors having floating charge—Debentures having floating charge are fully covered. Thus, they cannot be asked to bear any loss.
- (b) Unsecured Creditors—Since they are sufficiently covered, they also will not bear any loss.
- (c) Preference Shareholders—The claim of preference shareholders is not fully covered. Surplus assets available for likely distribution between preference and equity shareholders is Rs. 3,16,800 out of which the claim of preference shareholders including arrears of dividend is Rs. 4,03,200. In this situation, they will not only lose Rs. 86,400 but will also lose even more, considering time and expense in liquidation. Hence, they will find no alternative but to make an inevitable sacrifice. Since they are interested in getting berth in the equity capital, their sacrifice will naturally be commensurate to their aspiration and must be acceptable to the existing equity shareholders. It will be reasonable for them to forego the arrears of preference dividend in full and to accept Rs. 2,40,000 9% cumulative preference shares of Rs.100 each of the existing preference shares.

This will mean that in future they will continue to receive Rs. 21,600 as dividend which was earned by them previously and, therefore, their sacrifice will not be as heavy at it appears. In view of higher rate of dividend, the market value of preference shares will rise and the greater likelihood of the dividend being paid regularly.

(d) Equity Shareholders—The equity shareholders will be prepared to bear the balance of loss of Rs. 1,63,200 [i.e., Rs. 3,26,400—(Rs. 4,03,200 – Rs. 2,40,000)]. The loss will be Rs. 68 [i.e., Rs. 1,63,200)/(2,400)] per share. As a result, paid up value per share should be reduced from Rs. 100 to Rs. 32.

(4) Arrangement of working capital:

It is required to calculate the working capital need of the proposed reconstructed company in order to make the scheme viable before the arrangement of working capital. The working capital need is calculated as follows:

To instal a new plant To pay outstanding debenture interest To introduce further working capital so as to make current	Rs.	Rs. 1,20,000 14,400
assets double the current liabilities: Current liabilities [(1,20,000+28,800) × 2] Less: Existing current assets (76,000 + 68,000)	2,97,600 1,44,000	1,53,600
	Transition in the	2,88,000

Assuming that existing debenture-holders will provide half of the working capital need, Rs. 1,44,000 (i.e., Rs. 2,88,000 × ½) by taking up additional debentures at an increased rate of 10%. The remaining amount may be raised from the existing equity shareholders because there is little scope for bank assistance in form of loan. But the existing preference shareholders are desirous of an interest in the equity capital. However, it is not likely that equity shareholders would like to lose their control over the affairs of the company and they must retain the majority of shares. Under these situations, in order to retain control and to honour desire of the existing preference shareholders, remaining funds of Rs. 1,44,000 may be provided by two classes of shareholders equally, i.e., Rs. 72,000 each by equity and preference shareholders in the form of 4,500 equity shares of Rs. 32 each fully paid.

(5) Capital structure after proposed reconstruction:

The capital structure of the company will be as below:

- (i) 2,400 9% Cumulative Preference Shares of Rs. 100 each fully paid Rs. 2,40,000
- (ii) 6,900 Equity Shares of Rs. 32 each fully paid Rs. 2,20,800

(iii) 6% Debentures

(iv) 10% Debentures

(v) Total [(i) + (ii) + (iii) + (iv)]

Rs. 1,20,000

Rs. 144,000

Rs. 7,24,800

The authorised capital may be suggested at Rs. 8,00,000 consisting of 4,000 9% Cumulative Preference Shares of Rs. 100 each and 12,500 Equity Shares of Rs. 32 each.

(6) If the scheme is implemented, the Balance Sheet of the company will be as follows : .

Balance Sheet of Paradise India Ltd. as on March 31, 2005 (And Reduced)

Liabilities	Amount	Assets	Amount
oen Aseroppe Esergical Addito I	Rs	garante par mariliza y farifi	Rs.
Share Capital :	out profited		E COMPANY
Authorised	Skill Skill	Fixed Assets	
4,000 9% Cum. Pref. Shares		Patent Rights	36,000
of Rs. 100 each	4,00,000	Buildings	1,80,000
12,500 Equity Shares of		Plant and Machinery	3,60,000
Rs. 32 each	4,00,000	(2,40,000 + 1,20,000)	1
	8,00,000	Current Assets, Loans	
Issued and Subscribed		and Advances	76,000
2,400 9% Cum. Pref. Shares		Stock (Market value)	68,000
of Rs. 100 each	2,40,000	Debtors (Good)	
6,900 Equity Shares of		Bank	1,53,600
Rs. 32 each	2,20,800	(2,80,000 - 1,20,000 - 14,400)	median K
Secured Loans	A STATE OF THE OT	(14. K) 2.88.000 (15. k)	DUELL
6% Debentures	1,20,000	of the state of th	1 10 A
Unsecured Loans		Crassing Should a Depote Site of	N Marie
10% Debentures	1,44,000	West Service to the tree of the state of	September
Current Liabilities and			State Op
Provisions	Animalian San	and return designs to thingpine	of House R
Sundry Creditors	1,20,000	un de la companya de	Marit mile
Bank Overdraft	28,800	entrancia de la companya de la compa	1
	8,73,600		8,73,60

(7) Expected future profit and its likely disposal:

Unless the company, after internal reconstruction, is not sure of earning a profit of about 16% of its capital employed, i.e., Rs. 1,12,600 before interest and taxes, it will not be worthwhile to go ahead with the scheme. The likely disposal of expected profit will be:

(i)	For debenture interest (7,200 + 14,400)	Rs.	21,600
(ii)	For preference dividend (2,40,000 × 9%)	Rs.	21,600
(iii)	For equity dividend (2,20,800 × 10%)	Rs.	22,080
(iv)	For transfer to reserve (assumed)	Rs.	10,920
(v)	For paying taxes (may arise after 2 or 3 years because of set off		
	of past losses), say at 40% $[\{(ii)+(iii)+(iv)\}\times\{(40\%)/(60\%)\}]$	Rs.	36,400
(vi)	Total profits before interest and taxes [(i)+(ii)+(iii)+(iv)+(v)]	Rs. I	,12,600
			13. 36

We shall be glad to furnish any further information that you may require.

Thanking you,

Yours faithfully,

(Signature of the partner with seal)

Chartered Accountants.

7.9 Summary

With the compulsion of the compliance of AS-14, significant changes in accounting for amalgamations and mergers were noticed. In order to draft schemes on amalgamations and mergers, valuation of shares including goodwill, exchange ratio of shares, cash payment to avoid fraction, adequate provision for liquidation and formation expenses, etc. are required to be examined seriously. The 'outlines for amalgamation scheme' will help a lot in the matter of drafting the scheme of amalgamation.

While drafting schemes on internal reconstruction, it is required to follow the 'steps for internal reconstruction' in which different aspects, viz., losses to be written off, estimation of realisable value of assets in case of forced liquidation, writing off losses, compensation to those who will sacrifice, arrangement of adequate working capital, and estimation of expected future profits and its likely disposal, are to be discussed and demand careful and serious attention.

However, consent of all interested groups of the concerned companies is the primary need in case of amalgamation scheme. But in the case of internal reconstruction scheme, approval of the Court in addition to the consent of all interested parties of the company being reconstructed is a must. Nevertheless, an in-depth accounting knowledge is exclusively required for drafting any scheme, be it on amalgamation or on internal reconstruction. Schemes on amalgamations and mergers are drafted keeping in view the recommendations of AS-14.

7.10 Exercises

Problem 1:

Azad Ltd. and Hind Ltd. propose to amalgamate. Their Balance Sheets as on March 31, 2005 were as below:

Balance Sheets as on March 31, 2005

(Rs. in crore)

Liabilities	Azad Ltd.	Hind Ltd.	Assets	Azad Ltd.	Hind Ltd.
Equity Share Capital	Rs. 10.00	Rs. 4.00	Fixed Assets	Rs. 8.00	Rs. 2.00
(Shares of Rs. 100 each)			(less depreciation) Investment (Face	odi ilo salta	
General Reserve	4.00	0.40	value Rs. 2 crore in		
Profit and Loss A/c	2.00	0.60	6% Tax Free		- 0
Creditors	2.00	1.00	G. P. Notes)	2.00	HE V
			Stock	4.00	2.60
	1/4		Debtors	3.40	1.20
			Cash and Bank	0.60	0.20
	18.00	6.00		18.00	6.00

Net earnings after taxation (Rs. in crore)	Azad Ltd.	Hind Ltd.
For the year ended 31.3.2003	2.60	0.90
For the year ended 31.3.2004	2.50	0.80
For the year ended 31.3.2005	3,00	1.12

Goodwill may be taken at 4 years' purchase of average super profits from trading on the basis of 15% normal trading profit on closing capital invested. The stock of Azad Ltd. and Hind Ltd. to be taken at Rs. 4.08 crore and Rs. 2.84 crore respectively. Azad-Hind Ltd is formed for the purpose of amalgamation in the nature of purchase of both the companies.

Advise upon capitalisation of Azad-Hind Ltd. and suggest a scheme of amalgamation for that purpose. Draft the Balance Sheet of Azad-Hind Ltd.

Problem 2:

The two Companies, A Ltd. and B Ltd. are to be merged. Their Balance Sheets are as below:

Balance Sheets as on March 31, 2005

Liabilities	A Ltd.	B Ltd.	Assets	A Ltd.	B Ltd.
Ban viller en 126	Rs.	Rs.	au liev il brain de p	Rs.	Rs.
Equity Shares of			Fixed Assets	2,50,000	2,40,000
Rs.10 each	3,20,000	2,00,000	Stock	92,000	1,00,000
6% Pref. Shares of			Debtors	1,10,000	1,04,000
Rs.100 each	10000	80,000	Cash and Bank	18,000	26,000
8% Debentures	_	40,000			
General Reserve	32,000	32,000			E 1014
Profit & Loss A/c	70,000	70,000		S. Marine P. H.	
Creditors	48,000	48,000	910°278. donu	U.S. SOLE	
	4,70,000	4,70,000	4701	4,70,000	4,70,000

Profit and Loss Account balances are made up as follows:

	A Ltd.	B Ltd.
	(Rs.)	(Rs.)
Balance on 1.4.2004	14,000	14,000
Add: Profit before debenture interest during year ended 31.3.05	56,000	56,000
	70,000	70,000

Draft a scheme of merger.

Problem 3:

The following is the abridged Balance Sheet of Dark Ltd. as on March 31, 2005 :

Liabilities	Amount	Assets	Amount
III III III III III III III III III II	Rs.		Rs.
Paid up Capital :		Goodwill at cost	60,000
2,000 6% Cum. Preference		Net Tangible Assets	3,04,000
Shares of Rs. 100 each	2,00,000	Profit and Loss A/c	1,36,000
3,000 Eq. Shares of			
Rs. 100 each	3,00,000	American Company	
	5,00,000		5,00,000

Preference dividend is in arrear for three years. Net tangible assets are estimated to be worth Rs. 2,72,000. Annual expected profit will be Rs. 30,000.

Draft a scheme of internal reconstruction to be submitted to the Board of Directors.

Problem 4:

Udayachal Ltd. which suffered heavy losses in the past considers that the worst is over and that, on a sound reorganisation, it will be able to carry on business successfully, profits in future being expected to be between Rs. 1,00,000 and Rs. 1,36,000 before providing for interest but after charging adequate depreciation. The Balance Sheet of the company as on March 31, 2005 is as follows:

Liabilities	Amount	Assets	Amount
	Rs.	men le	Rs.
Share Capital:		Sundry Fixed Assets	Name of
4,800 6% Cum. Preference		(less Depreciation)	16,00,000
Shares of Rs. 100 each	4,80,000	Sundry Floating Assets	8,16,000
8,000 Equity Shares of		Cash at Bank	96,000
Rs. 100 each	8,00,000	Profit and Loss A/c	17,12,000
5% Debentures (Rs. 100 each)	21,44,000	in the suppoled fauchsit, sex. I	one of the co
Interest due on above	64,000		
Tax Liability	16,000		
Creditors (Unsecured)	7,20,000	6 = 1	
	42,24,000		42,24,000

Preference dividend is in arrear for two years. Debentures carry a floating charge on all assets of the company. Sundry fixed assets are worth Rs. 8,00,000 and the sundry floating assets are worth Rs. 6,40,000.

The Board of Directors of the company requests you to draft a scheme of internal reconstruction, which would be acceptable to all the interested groups.

Problem 5 :

North-East India Ltd. has experienced difficulties. It is decided to reconstruct the company internally. The following is the Balance Sheet as on March 31, 2005:

Liabilities	Amount	Assets	Amount
	Rs.		Rs.
Share Capital:		Land and Building	2,25,000
6,000 71/2% Pref. Shares of		Plant and Machinery	4,50,000
Rs. 100 each fully paid	6,00,000	Patents	60,000
4,500 Equity Shares of		Stock	2,25,000
Rs. 100 each fully paid	4,50,000	Debtors	90,000
6% Debentures (Rs. 100 each)	3,00,000	Cash at Bank	7,500
Trade Creditors	5,25,000	Profit and Loss A/c	8,17,500
	18,75,000	dellares built is some	18,75,500

An analysis of causes leading to losses in the past reveals that processes are outdated end that sufficient credit is not allowed. Modernisation of plant will cost Rs. 3,00,000; Rs. 1,50,000 worth of present plat being retired and sold for Rs. 30,000.

Two months' credit has to be allowed for sales to be maintained at their proper level of Rs. 18,00,000 leading to a profit before interest of Rs. 90,000.

Trade Creditors include Rs. 30,000 payable to preferential creditors. Land and Building is valued at Rs. 2,70,000 and Patents are worth only Rs. 15,000. Preference dividend is in arrear for four years. You may assume the company has to pay nothing for income tax for coming few years.

Submit your proposal for reconstruction of the company.

7.11 Questions

- Q.1 What do you mean by the terms 'scheme of amalgamation'? Explain different steps of the scheme of amalgamation?
- Q.2 What are the types of amalgamation? Explain each of them.
- Q.3 What is meant by scheme of amalgamation? What are the pre-requisites of internal reconstruction?
- Q.4 How can you draft a scheme of internal reconstruction which will be acceptable to all the interested groups of the company being reconstructed?

7.12 Suggested Readings

- 1. Chakraborty, H: Advanced Accountancy, Oxford University Press.
- Shukla, M.C; Grewal, T. S. & Gupta, S. C: Advanced Accounts, S. Chand & Co. (Pvt.) Ltd.
- 3. Maheshwari, S.N: Advanced Accountancy, Vikas Publishing House Pvt. Ltd.
- 4. The Institute of Chartered Accountants of India: Accounting Standard-14.

Unit 8 Segment Reporting

Structure

- 8.0 Objective
- 8.1 Introduction
- 8.2 General Meaning of Segment
- 8.3 Identification of Segment
 - 8.3.1 Business or Industrial Segment
 - 8.3.2 Geographical Segment
 - 8.3.3 Reportable Segment
 - 8.3.4 Primary and Secondary Segment
- 8.4 Need for Segment Reporting
- 8.5 Benefits of Segment Reporting
 - 8.5.1 Benefits of Segment Reporting from the point of view of Users
 - 8.5.2 Benefits of Segment Reporting from the point of view of Companies
- 8.6 Segment Accounting Policies
- 8.7 Disclosure Requirements of Segment Reporting as per AS-17
 - 8.7.1 Disclosures Based on Primary Reporting Format
 - 8.7.2 Disclosure Based on Secondary Reporting Format
 - 8.7.3 Other Disclosures
- 8.8 Summary
- 8.9 Questions
- 8.10 Suggested Reading

8.0 Objective

By the time you have gone through this unit you will be able to:

- know the meaning of segment;
- know the classification and identification of segment;
- know the benefits of segment reporting;
- know the segment accounting policies; and
- know the disclosure requirements of segment reporting as per AS-17.

8.1 Introduction

Presently, we are passing through the age of change where everything tends to change. Those who cannot adapt to the change become backbenchers. Keeping pace with the changes, different universities, professional accounting bodies, viz., ICAI, ICWAI, IIM, etc., and other educational institutions have been changing their course curricula. Financial reporting, a part of accounting, is not an exception to this rule. Users of financial information are not satisfied with the consolidated form of information. In addition, they require specific information for individual parts of the business. As a result, the ICAI has issued 'AS-17: Segment Reporting' for compliance in maintaining accounts and reporting thereof by Indian companies.

8.2 General Meaning of Segment

Generally 'segment' refers to a part cut off or a portion or a section of the totality. Likewise, in business, it means sectionalisation or categorisation of products or services and business zones of the company on the basis of dominance. In other words, dominating products or services and business zones of an enterprise are known as segments. Identification of segment into various categories is needed for providing useful information to the users.

8.3 Identification Segment

AS-17 distinguish between business segment and geographical segment and identifies the factors that are to be taken into consideration in their determination. Different types of segments along with the factors that are to be considered in their identification are explained in the paragraphs that follow.

8.3.1 Business or Industrial Segment

It is a distinguishable component of an enterprise that is engaged in providing an individual product or service or a group of related products or services and that is subject to risks and returns that are different from those of other business segments. Factors that should be considered in determining business or industrial segments include:

- (a) the nature of the products or services;
- (b) the nature of the production processes;
- (c) the type or class of customers for the products or services;

- (d) the methods used to distribute the products or provide the services; and
- (e) if applicable, the nature of the regulatory environment, for example, banking, insurance, or public utilities.

8.3.2 Geographical Segment:

It is a distinguishable component of an enterprise that is engaged in providing products or services within a particular economic environment and that is subject to risks and returns that are different from those of components operating in other economic environments. Factors that should be considered in identifying geographical segments include:

- (a) similarity of economic and political conditions;
- (b) relationships between operations in different geographical areas;
- (c) proximity of operations;
- (d) special risks associated with operations in a particular area;
- (e) exchange control regulations; and
- (f) the underlying currency risks.

8.3.3 Reportable Segment :

Once the business and geographical segments are identified, the management has to decide whether these segments are reportable segments. As per the Standard, a segment with 10% or more of total revenues, profit (or loss) or identifiable assets becomes a reportable segment. The Standard also stipulates that if total external revenue attributable to reportable segments constitutes less than 75% of the total revenue of the enterprise, additional segments should be identified as reportable segments, even if they do not meet the 10% criterion, to make the revenue of the reportable segments at least equivalent to 75% of total revenue of the enterprise. Thus, a segment may be considered as a reportable segment which satisfies the following test:

- Revenue Test—Segment revenue is 10% or more of the total revenue, external and internal, of all segments.
- (2) Profit or Loss Test—The absolute amount of segment operating profit or loss is 10% or more of the greater, in absolute amount, either of (a) combined profit of all segments reporting profit, or (b) combined loss of all segments reporting loss.
- (3) Asset Test—Segment assets are 10% or more of combined assets of all segments.
- (4) 75% Test—After the 10% tests are completed, a 75% test should be performed. The total external revenue of all reportable segments should be at least 75% of the total external revenues of all segments.

8.3.4 Primary and Secondary Segment:

After ascertainment of reportable segment, the management has to determine the segment either into (a) primary segment, or (b) secondary segment. The primary segment and secondary segment are determined by dominant source and nature of an enterprise's risk and returns as follows:

- (i) An enterprise's primary segments are business segments if its risks and returns are affected predominantly by differences in the products and services which it produces, and an enterprise's primary segments are geographical segments if its risks and returns are affected predominantly by the fact that it operates in different countries or geographical areas.
- (ii) When an enterprise's risks and returns are predominantly affected by the differences in both the products and services it sells and geographical areas where it operates, it should use business segments as primary segments and geographical segments as secondary segments.

8.4 Need for Segment Reporting

Many large companies are engaged in the production and distribution of different products or services not only to serve the home market but also to serve the global market. However, currently there has been a trend toward diversification, both by line of business and geographical area. Keeping this in view, large companies operate either in a number of industries or in a number of countries, or both. Again, many companies are so diversified that domestic operations account for a minority of total revenues and no single business sector predominates. Thus, business locations of companies are not confined to any country's territory; even it extends to any place of the world. This phenomenon has gained importance with the emergence of globalisation and liberalisation all over the world.

A business enterprise has to perform many functions including financial reporting for the users. In order to discharge financial reporting function, usually consolidated financial information is provided without disaggregating information on the basis of products or services and business locations. Providing this type of information will serve only the purpose of general assessment of the business. In this situation, some users are directly affected by only one part of the company's business. But the information need of the users is more than general information. Rather they are interested in getting segment information with a view to measuring the efficacy or otherwise of the segments so that they can evaluate the overall performance of a business enterprise in a better manner.

8.5 Benefits of Segment Reporting

The area of financial reporting where segment-wise financial reporting practices are followed, may be considered as Segment Reporting. Many large companies with diversified product lines and segments may differ from each other in respect of profitability, growth potential and risk. In this context, they essentially make segment reporting for highlighting different issues which are of immense help to the users of segment information in particular and consolidated information in general for measuring overall performance of companies. Segment reporting is surely beneficial to the users of financial information but it is also beneficial to the companies themselves in may respects. The benefits of segment reporting may be discussed from the point of view of companies and users as well, in the sub-heads that follow.

8.5.1 Benefits of Segment Reporting from the point of view of users

Users of information are benefited in a number of ways as below:

- (1) It helps in providing a complete picture of information as required by the users.
- (2) It helps the users in evaluating the efficiency or otherwise of each segment.
- (3) It helps to assess the safety and security of the funds invested by the investors.
- (4) It helps to create confidence or otherwise in the minds of the existing and prospective investors. As a result, they may invest their funds accordingly.
- (5) It helps in feeling good or otherwise in the matter of social security of the employees.
- (6) It helps the existing and prospective investors to understand the stock market reaction.

8.5.2 Benefits of Segment Reporting from the point of view of companies

Every company derives the following benefits from segment reporting:

- (1) The main benefit of segment reporting is that it enables prediction of future cash flows and the risk thereof.
- (2) It provides a complete picture of the affairs of each segment. The result of each segment may be suitably compared with those of similar other segments over a number of years. This will facilitate management control over the working of each segment.

- (3) It not only helps in explaining segment-wise performance but it also helps in exhibiting financial position which are required in framing policy-making exercise. Based on it, the management can take decision for business expansion or otherwise.
- (4) It helps to raise funds for anticipated expansion of the segments and the company as a whole.
- (5) It helps the management to take suitable measure, if any, to counter the challenges from adverse stock market reaction of its securities.
- (6) It helps management in taking decisions in respect of closing down or reorganising of a particular segment by the process of critical evaluation where segment reporting is in force. For example, a company as a whole might have been performing badly over the few years and if it is allowed to perform badly for another few years, the liquidation will be the only alternative of the company. In this situation, the management may think of either closing down or reorganising its business. But, where the segment accounting and reporting is in force, they may observe that a few segments are performing very badly and a few are performing satisfactorily. As a result, they may take the decision of closure or reorganisation of badly performed segments.

8.6 Segment Accounting Policies

As per AS-17, an enterprise should follow uniform segment accounting policies in the following lines:

- (1) Segment information should be prepared in conformity with the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole.
- (2) There is a presumption that the accounting policies that the directors and management of an enterprise have chosen to use in preparing the financial statements of the enterprise as a whole are those that the directors and management believe are the most appropriate for external reporting purposes. Since the purpose of segment information is to help users of financial statements to better understand and to make more informed judgements about the enterprise as a whole, the Standard requires the use, in preparing segment information, of the accounting policies adopted for preparing and presenting the financial statements of the enterprise as a whole. That does not mean, however, that the enterprise accounting policies are to be applied to reportable segments as if the segments were separate stand-alone reporting entities. A detailed calculation done in applying a

particular accounting policy at the enterprise-wide level may be allocated to segments if there is a reasonable basis for doing so. Pension calculations, for example, often are done for an enterprise as a whole, but the enterprise-wide figures may be allocated to segments based on salary and demographic data for the segments.

- (3) The Standard does not prohibit the disclosure of additional segment information that is prepared on a basis other than the accounting policies adopted for the enterprise financial statements of the enterprise provided that (a) the information is reported internally to the board of directors and the chief executive officer for purposes of making decisions about allocating resources to the segment and assessing its performance; and (b) the basis of measurement for this additional information is clearly described.
- (4) Assets and liabilities that relate jointly to two or more segments should be allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments.
- (5) The way in which asset, liability, revenue, and expense items are allocated to segments depends on such factors as the nature of those items, the activities conducted by the segment, and the relative autonomy of that segment. It is not possible or appropriate to specify a single basis of allocation that should be adopted by all enterprises; nor is it appropriate to force allocation of enterprise asset, liability, revenue, and expense items that relate jointly to two or more segments, if the only basis for making those allocations is arbitrary. At the same time, the definitions of segment revenue, segment expense, segment assets, and segment liabilities are interrelated, and the resulting allocations should be consistent. Therefore, jointly used assets and liabilities are allocated to segments if, and only if, their related revenues and expenses also are allocated to those segments. For example, an asset is included in segment assets if, and only if, the related depreciation or amortisation is included in segment expense.

8.7 Disclosure Requirements of Segment Reporting as per AS-17

As-17 deals with the disclosure of information on the basis of segment of an enterprise in the financial statements. The objective of segment reporting is to establish principles for reporting financial information in annual financial statements by segment, i.e., information about the different types of products and services an enterprise produces and the different geographical areas in which it operates.

For the purpose of disclosure of segmental information, the Standard also distinguishes between primary segment and secondary segment and suggests primary and secondary reporting formats respectively for them. For example, if risks and returns of an enterprise are affected predominantly by differences in the products and services it produces, its primary format for reporting segment information should be business segments, with secondary information reported geographically. Similarly, if risks and returns of an enterprise are affected predominantly by the fact that it operates in different countries or other geographical areas, its primary format for reporting segmental information should be geographical segments, with secondary information reported for groups of related products and services. The disclosure requirements are given in Sections 8.7.1, 8.7.2 and 8.7.3.

8.7.1 Disclosures Based on Primary Reporting Format

- An enterprise should disclose the following for each reportable segment based on primary reporting format:
 - (a) segment revenue, classified into segment revenue from sales to external customers and segment revenue from transactions with other segments;
 - (b) segment result;
 - (c) total carrying amount of segment assets;
 - (d) total amount of segment liabilities;
 - (e) total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets);
 - (f) total amount of expense included in the segment result for depreciation and amortisation in respect of segment assets for the period; and
 - (g) total amount of significant non-cash expenses, other than depreciation and amortisation in respect of segment assets, that were included in segment expense and, therefore, deducted in measuring segment result.
- 2. Paragraph 1. (b) requires an enterprise to report segment result. If an enterprise can compute segment net profit or loss or some other measure of segment profitability other than segment result, without arbitrary allocations, reporting of such amount(s) in addition to segment result is encouraged. If that measure is prepared on a basis other than the accounting policies adopted for the financial statements of the enterprise, the enterprise will include in its financial statements a clear description of the basis of measurement.
- 3 . An example of a measure of segment performance above segment result in the statement of profit and loss is gross margin on sales. Examples of measures of segment

performance below segment result in the statement of profit and loss are profit or loss from ordinary activities (either before or after income taxes) and net profit or loss.

- 4. AS-5, 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies' requires that "when items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately". Examples of such items include write-downs of inventories, provisions for restructuring, disposals of fixed assets and long-term investments, legislative changes having retrospective application, litigation settlements, and reversal of provisions. An enterprise is encouraged, but not required, to disclose the nature and amount of any items of segment revenue and segment expense that are of such size, nature, or incidence that their disclosure is relevant to explain the performance of the segment for the period. Such disclosure is not intended to change the classification of any such items of revenue or expense from ordinary to extraordinary or to change the measurement of such items. The disclosure, however, does change the level at which the significance of such items is evaluated for disclosure purposes from the enterprise level to the segment level.
 - 5. An enterprise that reports the amount of cash flows arising from operating, investing and financing activities of a segment need not disclose depreciation and amortisation expense and non-cash expenses of such segment pursuant to sub-paragraphs (f) and (g) of paragraph 1.
 - 6. AS-3, Cash Flow Statements, recommends that an enterprise should present a cash flow statement that separately reports cash flows from operating, investing and financing activities. Disclosure of information regarding operating, investing and financing cash flows of each reportable segment is relevant in understanding the enterprise's overall financial position, liquidity, and cash flows. Disclosure of segment cash flow is, therefore, encouraged, though not required. An enterprise that provides segment cash flow disclosures need not disclose depreciation and amortisation expense and non-cash expenses pursuant to sub-paragraphs (f) and (g) of paragraph 1.
 - 7. An enterprise should present a reconciliation between the information disclosed for reportable segments and the aggregated information in the enterprise financial statements. In presenting the reconciliation, segment revenue should be reconciled to enterprise revenue; segment result should be reconciled to enterprise net profit or loss; segment assets should be reconciled to enterprise assets; and segment liabilities should be reconciled to enterprise liabilities.

In fulfilling the disclosure requirements, we must remember, for each reportable segment, the following:

- 1. A segment identified as a reportable segment in the immediately preceding period because it satisfied the relevant 10% criterion should continue to be a reportable segment for the current period notwithstanding that its revenue, result, and assets all no longer meet the 10% criterion.
 - 2. If a segment is identified as a reportable segment in the current period because it satisfies the relevant 10% criterion, preceding-period segment data that is presented for comparative purposes should, unless it is impracticable to do so, be restated to reflect the newly reportable segment as a separate segment, even if that segment did not satisfy the 10% criterion in the preceding period.

8.7.2 Disclosure Based on Secondary Reporting Format

- 1. Disclosure requirements for each reportable segment based on secondary reporting format of an enterprise are as follows:
 - (a) if primary format of an enterprise is business segments, the required secondary-format disclosures are given in paragraph 8.7.2.(2);
 - (b) if primary format of an enterprise is geographical segments based on location of assets (where the products of the enterprise are produced or where its service rendering operations are based), the required secondary-format disclosures are presented in paragraphs 8.7.2.(3) and 8.7.2.(4);
 - (c) if primary format of an enterprise is geographical segments based on the location of its customers (where its products are sold or services are rendered), the required secondary-format disclosures are shown in paragraphs 8.7.2.(3) and 8.7.2.(4).
- If primary format of an enterprise for reporting segment information is business segments, it should also report the following information:
 - (a) segment revenue from external customers by geographical area based on the geographical location of its customers, for each geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue;
 - (b) the total carrying amount of segment assets by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments; and
 - (c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by geographical location of assets, for each geographical segment whose segment assets are 10% or more of the total assets of all geographical segments.

- 3. If primary format of an enterprise for reporting segment information is geographical segments (whether based on location of assets or location of customers), it should also report the following segment information for each business segment whose revenue from sales to external customers is 10% or more of enterprise revenue or whose segment assets are 10% or more of the total assets of all business segments:
 - (a) segment revenue from external customers;
 - (b) the total carrying amount of segment assets; and
 - (c) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets).
- 4. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of assets, and if the location of its customers is different from the location of its assets, then the enterprise should also report revenue from sales to external customers for each customer-based geographical segment whose revenue from sales to external customers is 10% or more of enterprise revenue.
- 5. If primary format of an enterprise for reporting segment information is geographical segments that are based on location of customers, and if the assets of the enterprise are located in geographical areas different from its customers, then the enterprise should also report the following segment information for each asset-based geographical segment whose revenue from sales to external customers or segment assets are 10% or more of total enterprise amounts:
 - (a) the total carrying amount of segment assets by geographical location of the assets;
 and
 - (b) the total cost incurred during the period to acquire segment assets that are expected to be used during more than one period (tangible and intangible fixed assets) by location of the assets.

8.7.3 Other Disclosures

An enterprise should comply with other disclosure requirements for its reportable segment in the following lines:

 In measuring and reporting segment revenue from transactions with other segments, inter-segment transfers should be measured on the basis that the enterprise actually used to price those transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements.

- Changes in accounting policies adopted for segment reporting that have a material
 effect on segment information should be disclosed. Such disclosure should include a
 description of the nature of the change, and the financial effect of the change if it is
 reasonably determinable.
- 3. AS-5 requires that changes in accounting policies adopted by the enterprise should be made only if required by statute, or for compliance with an accounting standard, or if it is considered that the change would result in a more appropriate presentation of events or transactions in the financial statements of the enterprise.
- 4. Changes in accounting policies adopted at the enterprise level that affect segment information are dealt with in accordance with AS-5. AS-5 requires that any change in an accounting policy which has a material effect, should be disclosed. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on

material statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

- 5. Some changes in accounting policies relate specifically to segment reporting. Examples include changes in identification of segments and changes in the basis of allocating revenues and expenses to segments. Such changes can have a significant impact on the segment information reported but will not change aggregate financial information reported for the enterprise. To enable users to understand the impact of such changes, the Standard requires the disclosure of the nature of the change and the financial effect of the change, if reasonably determinable.
- 6. An enterprise should indicate the types of products and services included in each reported business segment and indicate the composition of each reported geographical segment, both primary and secondary, if not otherwise disclosed in the financial statements.
- 7. To assess the impact of such matters as shifts in demand, changes in the prices of inputs or other factors of production, and the development of alternative products and processes on a business segment, it is necessary to know the activities encompassed by that segment. Similarly, to assess the impact of changes in the economic and political environment on the risks and returns of a geographical segment, it is important to know the composition of that geographical segment.

AS-17 was mandatory with effect from the accounting year commencing on or after 1.4.2001 for (a) listed companies or companies whose shares and debentures are in the process of enlisting on a recognised stock exchange in India as evidenced by the board of directors' resolution in this regard; and (b) all other commercial, industrial and business enterprises whose turnover for the accounting period exceeds Rs.50 crore.

8.8 Summary

Segment reporting is made for both the internal and external purposes. It plays an important role in disseminating disaggregated information to the users. Users of information may feel good in evaluating segment performance and overall performance of the company. This might encourage them. Stock market might show its reaction. Segment reporting also helps the management in framing policy decisions and in measuring growth potential, risks and returns. When segment reporting is used for internal purposes, it provides an opportunity to the management to keep constant watch over the bad and good performing segments. As a result, they can take corrective measures for the badly performing segment. They can also think about expansion for good performing segment with a view to enhancing overall profit of the company.

8.9 Questions

- Q.1 What do you mean by segment as used in business? How would you identify segment into different types?
- Q.2 What is segment reporting? Why is segment reporting needed? What are the benefits of segment reporting?
- Q.3 Are all companies bound to comply with the disclosure requirements under AS-17? State the disclosures that are to be made for each reportable segment based on the primary reporting format.
- Q.4 How would you distinguish between primary segment and secondary segment? What are the disclosure requirements that are to be made for each reportable segment based on the secondary reporting format?
- Q.5 Why should uniform accounting policies to be followed in segment reporting? What are the other disclosures in segment reporting?

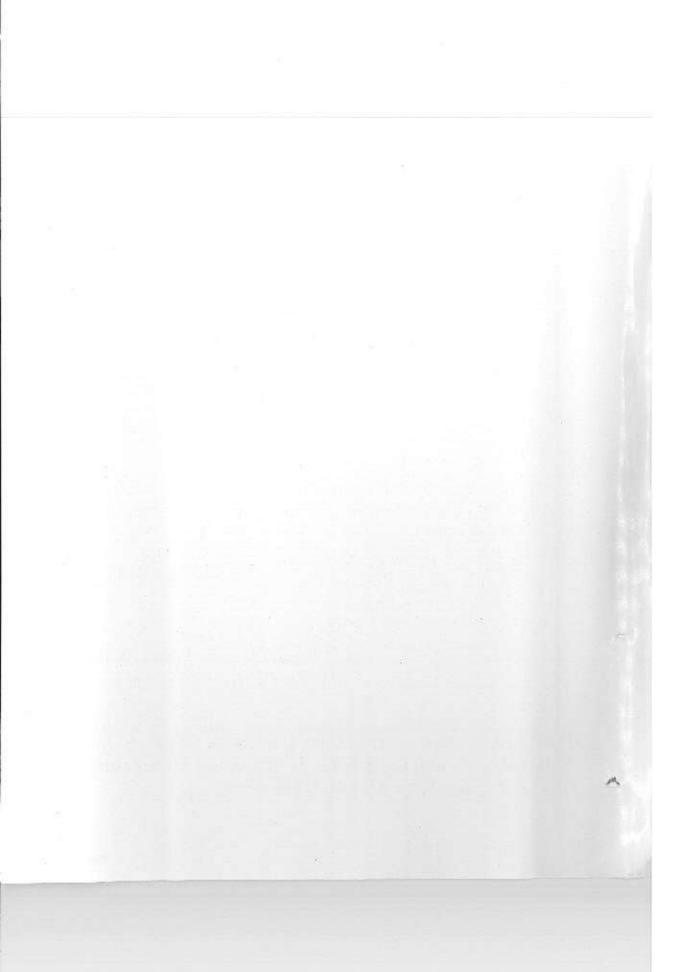
8.10 Suggested Readings

- 1. Schedule VI of the Companies Act, 1956 (Relevant portion).
- 2. Banerjee, B: Regulation of Corporate Accounting and Reporting in India, World Press Pvt. Ltd.
- Sen, S: "Segment Reporting—An Overview" in Banerjee, B. and Basu, A. K. (ed.), Corporate Financial Reporting, DSA in Commerce, Calcutta University, 2001.
- 4. The Institute of Chartered Accountants of India: Accounting Standard-17.
- 5. The Securities and Exchange Board of India: Guidelines and Regulations (Relevant portion).

\$10 Suggested Rendings

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মানুষের জ্ঞান ও ভাবকে বইয়ের মধ্যে সঞ্জিত করিবার যে একটা প্রচুর সুবিধা আছে, সে কথা কেহই অস্বীকার করিতে পারে না। কিন্তু সেই সুবিধার দ্বারা মনের স্বাভাবিক শক্তিকে একেবারে আচ্ছর করিয়া ফেলিলে বুন্দিকে বাবু করিয়া তোলা হয়।

—রবীদ্রনাথ ঠাকুর

ভারতের একটা mission আছে, একটা গৌরবময় ভবিষ্যৎ আছে, সেই ভবিষ্যৎ ভারতের উত্তরাধিকারী আমরাই। নৃতন ভারতের মৃত্তির ইতিহাস আমরাই রচনা করছি এবং করব। এই বিশ্বাস আছে বলেই আমরা সব দুঃখ কস্ট সহ্য করতে পারি, অন্থকারময় বর্তমানকে অগ্রাহা করতে পারি, বাস্তবের নিষ্ঠুর সত্যগুলি আদর্শের কঠিন আঘাতে ধূলিসাৎ করতে পারি।

–সূভাষচন্দ্র বসূ

Any system of education which ignores Indian conditions, requirements, history and sociology is too unscientific to commend itself to any rational support.

–Subhas Chandra Bose

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