INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 5

ADVANCED ACCOUNTING

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Study Material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

Revised Edition	:	July, 2015
Website	:	www.icai.org
E-mail	:	bos@icai.in
Committee/ Department	:	Board of Studies
ISBN No.	:	
Price(All Modules)	:	
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002, India.
Printed by	:	

A WORD ABOUT STUDY MATERIAL

Accounting constitutes a very significant area of core competence for chartered accountants. The paper of 'Advanced Accounting' at Intermediate (IPC) level concentrates on conceptual understanding of the crucial aspects of accounting.

This paper will acquaint you with the basic concepts, theories and accounting techniques followed by few different entities and expects you to gain working knowledge of few more professional standards and application of accounting principles to different practical situations.

The study material deals with the conceptual theoretical framework in detail. This Study Material has been designed having regard to the needs of home study and distance learning students. The students are expected to cover the entire syllabus and also practice solving the questions given in the practice manual on their own.

The main features of the study material as under:

- The entire syllabus has been divided into Eight chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and can tackle the exercises.
- Many illustrations have been included in each chapter of the Study Material.
- In this revised study material, sincere efforts and care has been taken to incorporate the relevant amendments.

- ***The Study Material has been revised in line with the relevant sections of the Companies Act, 2013 which have come into force.***
- Flow charts have been inserted in Chapters at appropriate places for quick reference of students.

- Any theoretical additions made in the chapters have been highlighted in bold and italics while practical illustrations have been highlighted with grey shading in the Study Material for easy identification and quick reference.
- In this revised edition, efforts have been taken to standardize the format of the solutions to the practical problems as far as possible.
- Feedback form is given in the study material wherein students are encouraged to give their feedback/suggestions.

From November, 2015 examination and onwards the topic "Financial Statements of Electricity Companies" has been excluded from the syllabus, therefore, the same has been removed from the Study Material.

These features would add value to the study material and aid the students in the learning process. In case you need any further clarification/guidance, you may send your queries at; seema@icai.in, shilpa@icai.in; asha.verma@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014 EDITION

Chapter no./unit no.	Name of Chapter/	Name of Unit	Section/ Sub-section	Changes
Chapter 2	Accounting Standards		2.1 AS 4: Contingencies and Events Occurring After the Balance Sheet Date	Illustration 4 added
			2.2 AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Illustration 8 added
			2.3 AS 11: The Effects of Changes in Foreign Exchange Rates	Illustration 10 added
				Applicability of Para 46 for Entities other than Companies added
			2.5 AS 16: Borrowing Costs	Illustration 21 added
			2.8 AS 26: Intangible Assets	Illustration 34 added
			2.9 AS 29: Provisions, Continent Liabilities and Contingent	Illustration 35 added

			Assets	
Appendix III	Accounting Standards		AS 11 "The effects of changes in foreign exchange rates"	Para 46 for Entities other than Companies added at the end of the Standard.
Chapter 3- Unit 2	Advanced Issues in partnership Accounts	Amalgamation, Conversion and Sale of Partnership Firms	2.2 Conversion of partnership Firm into Company	Illustration 9 added
Chapter 4- Unit 1	Company Accounts	ESOP and Buy back of Shares	1.1 Employees Stock Option Plan	Para amended
Chapter 4- Unit 4		Amalgamation and Reconstruction	4.3 Advanced Problems	Illustration 14 added
Chapter 5 – Unit 1	Financial Statements of Insurance Companies	Introduction to Insurance Business	1.6 Insurance Regulatory and Development Authority Act, 1999 (Amendments)	Matter added
Chapter 5 – Unit 3		Financial Statements of Insurance Companies	3.5 Preparation of Financial Statements	Illustration 3 added
Chapter 6- Unit 1	Financial Statements of Banking Companies	Relevant Provisions of the Banking Regulation Act	1.10 Liquidity Norms	Amended
Chapter 6- Unit 3		Capital Adequacy Norms	3.1 Capital Frameworks of Banks in India	Amended
Chapter 6- Unit 4		Income Recognition, Classification of Assets and Provisions	4.2 Classification of Bank Advances	Matter added under para on Reschedulement / Restructuring /Renegotiation of Advances

			4.3 Provisions	Rate of provisioning for Non-performing Assets amended. Matter related to principle for creation of floating provisions and Interest Suspense Account added.
			4.4 Classification of Investments	Para related to Held-to-Maturity, (HTM) amended
Chapter 7	Departmental Accounts		8. Miscellaneous Illustrations	Illustration 7 added
Chapter 8	Branch Accounts		5. Accounting for dependent Branches	Illustration 3 added

STUDY PLAN – KEY TO EFFECTIVE LEARNING

Understand the syllabus

To start your preparation for the subject, it is necessary to understand clearly what is to be studied, from where to be studied and then how to be studied. Let's start with the first step in the process of your preparation. At the initial stage of preparation, one should study the syllabus carefully; also try to understand the relationships between various topics and the depth of the study required in different topics. The study material of Paper 5 'Advanced Accounting' is divided into nine chapters/topics based on the syllabus. The topics covered under this paper can be comprehended in the following manner:

Category	Name of the chapters
Topics on Accounting Standards	Chapter 1 Framework for Preparation and Presentation of Financial Statements Chapter 2: Accounting Standards
Partnership form of business	Chapter 3: Advanced issues in Partnership Accounts including issues related with LLP
Company form of business	Chapter 4: Company Accounts
Industry specific Financial statements	Chapter 5: Financial Statements of Insurance Companies Chapter 6: Financial Statements of Banking Companies
Accounting for Special Transactions	Chapter 7: Departmental Accounts Chapter 8: Accounting for Branches including Foreign Branches

Gather the course-ware to study

Once you acquaint yourself with the syllabus, the next step is to gather the knowledge inputs which have been provided by the Board of Studies, to study the paper.

1. **Study Material**
2. **Practice Manual**

Board of studies at the time of registration provides you the above two books.

3. **Suggested Answers**

After announcement of results, the suggested answers of the questions asked in that particular attempt are issued by the Board of studies.

4. **Revision Test Papers**

For every examination, Board of studies comes out with Revision Test Papers (RTP) meant for that particular attempt. However, in Accounts, you may refer RTPs of past few attempts.

5. **Mock Test Papers**

Mock Test Papers are also issued by the Board of Studies time to time. These mock test papers are based on the pattern of the question paper of the past examination.

Now, after knowing the various knowledge inputs provided by the Board of Studies, you should plan your studies accordingly. As stated earlier that all the course-ware mentioned above is not provided to you at the same time, hence one can comprehend that the objective of each knowledge input provided is different and requires your practice of the same, at different stage of your study.

How to study?

There is a very popular saying that if you fail to plan then you plans to fail. Planning is one of the essential elements for studying a subject of professional course. By planning, here we mean time management for subject as a whole and individually as well for each and every chapter. We would like to state that for the paper of accounting, one needs at least three rounds of study.

Advanced Accounting examination paper is purely practical based. Therefore, one has to do written practice of good number of questions on each topic. So, at the time of planning the study for accounting you should keep into mind the written practice of practical questions also. Considering the practical nature of the paper, start your studies from the day you receive the course material.

Keeping in mind the quantum of the syllabus, it is suggested that you should study one to two hours a day. By doing so, you will be able to manage first round of complete study and two rounds of revision well before time. Your first round of study should be completed well in advance that is at least three months before your exam. However, your planning should be based on the availability of time and the contents of the subject.

Your second round of study i.e. your first revision should be over before one month of your exam. Your second revision should be in the last month before exam so that you will be in the position to remember all the concepts. These three rounds of study will help in boosting the confidence level for the subject and will make you mentally prepared to appear in the examination.

Schedule

First round of study

Similar to the paper of Accounting, the syllabus of 'Advanced Accounting' also covers Accounting Standards as well as other topics, so here also, your planning should be divided in two parts namely-

1. Accounting Standards
2. Other chapters of the course curriculum.

Every day when you start your study first go through the concepts which you have read last day then start learning new concepts. Remember, out of sight, out of mind. Ideally your first study should be within 24 hours of initial reading, the second within 1 week of reading.

In Paper 1 'Accounting' at Intermediate (IPC) Course Group I level, we already had chapters on Partnership firm and Company accounts which dealt with some of the aspects of such form of businesses. Like in partnership, aspects of admission, retirement or death of a partner have been dealt with and the topics of company's accounts dealt with the issue of bonus shares, amalgamation, internal reconstruction etc.

The paper of 'Advanced Accounting' covers some more aspects of partnership firm and company accounts. Therefore, we in this paper recommend you to take these topics first as you are familiar with the accounting treatment followed in such types of businesses and will be in a position to grasp quickly the accounting treatment to be done for other aspects covered in this paper. However, considering the importance of these topics, unit on amalgamation and internal reconstruction has been included in this paper also.

For other topics, you may decide, at your convenience as to which topic should be taken up next and in what sequence. However, for this paper, we suggest you to study accounting standards at the end as we do not have any chapter which is specifically based on the provisions of accounting standards though accounting standards may apply in some situations like for valuation of investments of banks you may have to apply the provisions of AS 13 if nothing is specified in the Banking Regulations or the RBI Act in this regard.

Again in this paper also, we would like to re-iterate that for accounting standards, study the explanation given in chapter 2 first and then study the bare text of the accounting standard given as an appendix at the end, after chapter 9 of the study material. Following this procedure will help you in-depth understanding of the underlying concepts of accounting standards specified in the syllabus and the manner in which it is interpreted and should be interpreted.

Use of BoS Knowledge inputs in a systematic pattern

Step 1 Study material

To lay a strong foundation of the understanding of any particular topic, study material explains the concepts of each and every topic in detail with adequate illustrations. Study the underlying concepts and accounting treatment specified therein analytically before proceeding towards illustrations. Keep questioning yourself until you are absolutely clear on the topic. Solve the illustrations after understanding the topic.

Step 2 Practice Manual

After solving the illustrations given in the study material, solve the questions given in the practice manual. Practice Manual is highly useful for the students appearing in the examination as it includes questions from past examinations which would facilitate in thorough understanding of the chapters explained in the study material. In Advanced Accounting paper, it is very necessary that one should practice a good number of questions dealing with different adjustments. Practice Manual will help serve this purpose. Your first round of study should cover both Study Material and Practice Manual.

Second round of study

Step 3 Suggested answers

Your second round of study i.e. your first revision should cover practice of suggested answers of recent two to three examinations. Suggested answers of past few examinations give you an idea of what type of questions are asked in the examination and how to solve and present the solution for such questions in the examination. Solving the question paper in the examination situation will help you, not only in time management but will also give you the confidence to attempt different types of questions in the examination.

Step 4 Revision Test Papers (RTP)

After you complete revision of whole syllabus at least once, you should solve the questions given in the RTP. For every examination, Board of Studies comes out with a Revision Test Paper. Revision Test Paper is issued for every attempt containing a fresh set of questions which will help you to evaluate your preparation level. RTP of Advanced Accounting is divided into two parts namely Part I: Recent amendments, Notifications and Announcements which are relevant for that particular examination and are not given in the study material or were not applicable in the immediate past examination. You will be able to know all such relevant information applicable for the exam at one place. Part II carries questions and answers for your practice. In Advanced Accounting, questions on each topic are given with full solution to enable you to get an insight on how to present the solutions in an orderly manner. In Advanced Accounting paper, RTP of past few attempts can also be referred subject to amendments for which you have to refer the latest Study Material and RTP.

Third round of study

Step 5 Mock Test Papers

After second revision of the complete syllabus, you may assess your preparation by taking mock tests conducted by various branches at their end. Also Mock test papers are hosted on the institute's website www.icai.org which you may download and solve within a time period of three hours.

Important points to be kept in mind

1. Preparation of notes

Prepare concise notes in the first round of study itself. Your notes should be prepared in a manner, which supplements your understanding of the concept and the illustrations you have solved. You may either make a separate copy where you write down the important concepts of the chapter or can underline the important concepts in the book itself and read those underlined portion at the time of revision. You should also shortlist the illustrations to be revised again in your second and third round of study. Short listing of illustrations should be based on the difficulty you faced while solving the question. Besides preparation of important points of the topic (which will help you to recapitulate the whole concepts), a summary of tricky points and adjustments gathered from the practice of various good illustrations may also be prepared which will help in grasping the intricate practical aspects. Such tricky points or adjustments should be cross linked with the concerned illustration number so that at the time of revision you not only study the accounting treatment but also refer the whole solution again. These notes may also be accompanied by the proforma of relevant accounts and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and efforts without going through a number of books again.

2. Use of proper and prescribed format for presentation of accounts

There are some chapters which require the solution or financial statements to be presented in particular format. You should make it a practice to adopt the prescribed formats while presenting the accounts of particular entities. For example: Financial Statements of companies should be in the format prescribed in the Schedule III to the Companies Act, 2013.

3. Recapitulation of previously read topics

The chapter of Partnership accounts was also there in the paper of 'Fundamentals of Accounting' at CPT level. Therefore, here at Intermediate (IPC) Course level, you are required to whet your skills on this topic. Also the concepts and provisions read at CPT level lays down the foundation for studying and understanding the topics specified at the Intermediate (IPC) Course level. For example, concept of revenue and capital receipt and expenditure is applied in every topic while preparing the financial statements of an entity. Similarly, valuation of inventory, accounting for depreciation etc. are some of the topics the concepts of which are applied in general to all entities.

4. Keep yourself continuously updated

We at Board of studies endeavor to update you with the latest amendments or notifications as and when they are issued. One of the sections in the Students' Journal is on 'Academic Update' which contains recent amendments in accounting also. You should be in a habit to read this continuously as it will help you in avoiding last moment pressure to acquaint yourself with all the relevant amendments. Also list of publications comprising of all relevant accounting standards and guidance notes are published well in time in the Students' Journal and the institute's website to apprise you with the applicability part of the same in the particular examination.

5. Keep in mind the Inter-linking of various topics

The provisions of accounting standards have to be kept in mind and applied while studying the related chapter based on the particular accounting standard. If your concepts are clear relating to a particular standard, you should not face any problem in applying the same to solve problems in an inter-connected chapter. Sometimes even though the chapter may not directly relate to an accounting standard, it may contain adjustments involving application of one or more standards.

Tips for examination

Following are accounting related examination tips which you should keep in mind at the time of appearing for the examination:

1. Use of proper formats

Certain statutes prescribe specific formats for presentation of the accounts. You should take care of the same at the time of solving the questions in the exam. Accounts presented in the prescribed manner will help you in scoring due marks.

2. Adequate Working Notes

In accounts, your solution is generally divided in two parts viz- main solution and working notes. Working notes form part of your solution and carries marks. Therefore, it is advised that calculations made on your calculator should also be written in your answer sheet as working note, wherever required, neatly and precisely. Also your working note should be cross referenced with the figure used in the main solution so that examiner can easily understand that how you have arrived at the particular figure.

3. Answer the questions with due emphasis on the provisions of Accounting Standards

Support your answers/conclusions with proper reasoning. Answers for questions based on accounting standards should be supported with provisions of that accounting standard rather than a mere common sense or guess work. It is not required to quote paragraph number of Accounting standard but you are expected to quote accounting standard number along with the name of the standard. However, if you state, paragraph number of accounting standard, then it will add value to the solution and will also help create a good impression in the mind of the examiner. You should quote number of accounting standard or name only when you are sure. It is better not to quote than to misquote the accounting standard number.

4. State the assumption clearly

In case a question leaves room for making an assumption and there is a possibility of more than one assumption, it is important to clearly state the assumption you have taken and solve the question accordingly.

Happy Reading and Best Wishes!

SYLLABUS

GROUP II
PAPER 5: ADVANCED ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge: Working Knowledge

Objectives:

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

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

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

Contents :

1. Framework for Preparation and Presentation of Financial Statements

2. Accounting Standards

Working knowledge of:

AS 4 : Contingencies and Events occurring after the Balance Sheet Date

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

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

AS 12 : Accounting for Government Grants

AS 16 : Borrowing Costs

AS 19 : Leases

AS 20 : Earnings Per Share

AS 26 : Intangible Assets

AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

3. **Advanced Issues in Partnership Accounts and Issues related to accounting in Limited Liability Partnerships**

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

4. **Company Accounts**

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

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

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

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

5. **Accounting for Special Transactions**

   Departmental and branch accounts including foreign branches

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

CONTENTS

DETAILED CONTENTS : MODULE – 1

INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 5

ADVANCED ACCOUNTING

MODULE – 1

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Study Material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

Permission of the Institute is essential for reproduction of any portion of this material.

Revised Edition	:	July, 2015
Website	:	www.icai.org
E-mail	:	bos@icai.in
Committee/ Department	:	Board of Studies
ISBN No.	:	
Price(All Modules)	:	
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002, India.
Printed by	:	

A WORD ABOUT STUDY MATERIAL

Accounting constitutes a very significant area of core competence for chartered accountants. The paper of 'Advanced Accounting' at Intermediate (IPC) level concentrates on conceptual understanding of the crucial aspects of accounting.

This paper will acquaint you with the basic concepts, theories and accounting techniques followed by few different entities and expects you to gain working knowledge of few more professional standards and application of accounting principles to different practical situations.

The study material deals with the conceptual theoretical framework in detail. This Study Material has been designed having regard to the needs of home study and distance learning students. The students are expected to cover the entire syllabus and also practice solving the questions given in the practice manual on their own.

The main features of the study material as under:

- The entire syllabus has been divided into Eight chapters.
- In each chapter, learning objectives have been stated. The learning objectives would enable you to understand the sequence of various aspects dealt within the chapter before going into the details so that you know the direction of your studies.
- In each chapter, the topic has been covered in a step by step approach. The text has been explained, where appropriate, through illustrations and practical problems. You should go through the chapter carefully ensuring that you understand the topic and can tackle the exercises.
- Many illustrations have been included in each chapter of the Study Material.
- In this revised study material, sincere efforts and care has been taken to incorporate the relevant amendments.
- ***The Study Material has been revised in line with the relevant sections of the Companies Act, 2013 which have come into force.***
- Flow charts have been inserted in Chapters at appropriate places for quick reference of students.

- Any theoretical additions made in the chapters have been highlighted in bold and italics while practical illustrations have been highlighted with grey shading in the Study Material for easy identification and quick reference.
- In this revised edition, efforts have been taken to standardize the format of the solutions to the practical problems as far as possible.
- Feedback form is given in the study material wherein students are encouraged to give their feedback/suggestions.

From November, 2015 examination and onwards the topic "Financial Statements of Electricity Companies" has been excluded from the syllabus, therefore, the same has been removed from the Study Material.

These features would add value to the study material and aid the students in the learning process. In case you need any further clarification/guidance, you may send your queries at; seema@icai.in, shilpa@icai.in; asha.verma@icai.in.

SIGNIFICANT ADDITIONS/MODIFICATIONS IN 2015 EDITION OVER 2014 EDITION

Chapter no./unit no.	Name of Chapter/	Name of Unit	Section/ Sub-section	Changes
Chapter 2	Accounting Standards		2.1 AS 4: Contingencies and Events Occurring After the Balance Sheet Date	Illustration 4 added
			2.2 AS 5: Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies	Illustration 8 added
			2.3 AS 11: The Effects of Changes in Foreign Exchange Rates	Illustration 10 added
				Applicability of Para 46 for Entities other than Companies added
			2.5 AS 16: Borrowing Costs	Illustration 21 added
			2.8 AS 26: Intangible Assets	Illustration 34 added
			2.9 AS 29: Provisions, Continent Liabilities and Contingent	Illustration 35 added

			Assets	
Appendix III	Accounting Standards		AS 11 “The effects of changes in foreign exchange rates”	Para 46 for Entities other than Companies added at the end of the Standard.
Chapter 3-Unit 2	Advanced Issues in partnership Accounts	Amalgamation, Conversion and Sale of Partnership Firms	2.2 Conversion of partnership Firm into Company	Illustration 9 added
Chapter 4-Unit 1	Company Accounts	ESOP and Buy back of Shares	1.1 Employees Stock Option Plan	Para amended
Chapter 4-Unit 4		Amalgamation and Reconstruction	4.3 Advanced Problems	Illustration 14 added
Chapter 5 – Unit 1	Financial Statements of Insurance Companies	Introduction to Insurance Business	1.6 Insurance Regulatory and Development Authority Act, 1999 (Amendments)	Matter added
Chapter 5 – Unit 3		Financial Statements of Insurance Companies	3.5 Preparation of Financial Statements	Illustration 3 added
Chapter 6-Unit 1	Financial Statements of Banking Companies	Relevant Provisions of the Banking Regulation Act	1.10 Liquidity Norms	Amended
Chapter 6-Unit 3		Capital Adequacy Norms	3.1 Capital Frameworks of Banks in India	Amended
Chapter 6-Unit 4		Income Recognition, Classification of Assets and Provisions	4.2 Classification of Bank Advances	Matter added under para on Reschedulement / Restructuring /Renegotiation of Advances

			4.3 Provisions	Rate of provisioning for Non-performing Assets amended. Matter related to principle for creation of floating provisions and Interest Suspense Account added.
			4.4 Classification of Investments	Para related to Held-to-Maturity, (HTM) amended
Chapter 7	Departmental Accounts		8. Miscellaneous Illustrations	Illustration 7 added
Chapter 8	Branch Accounts		5. Accounting for dependent Branches	Illustration 3 added

STUDY PLAN – KEY TO EFFECTIVE LEARNING

Understand the syllabus

To start your preparation for the subject, it is necessary to understand clearly what is to be studied, from where to be studied and then how to be studied. Let's start with the first step in the process of your preparation. At the initial stage of preparation, one should study the syllabus carefully; also try to understand the relationships between various topics and the depth of the study required in different topics. The study material of Paper 5 'Advanced Accounting' is divided into nine chapters/topics based on the syllabus. The topics covered under this paper can be comprehended in the following manner:

Category	Name of the chapters
Topics on Accounting Standards	Chapter 1 Framework for Preparation and Presentation of Financial Statements Chapter 2: Accounting Standards
Partnership form of business	Chapter 3: Advanced issues in Partnership Accounts including issues related with LLP
Company form of business	Chapter 4: Company Accounts
Industry specific Financial statements	Chapter 5: Financial Statements of Insurance Companies Chapter 6: Financial Statements of Banking Companies
Accounting for Special Transactions	Chapter 7: Departmental Accounts Chapter 8: Accounting for Branches including Foreign Branches

Gather the course-ware to study

Once you acquaint yourself with the syllabus, the next step is to gather the knowledge inputs which have been provided by the Board of Studies, to study the paper.

1. **Study Material**
2. **Practice Manual**

Board of studies at the time of registration provides you the above two books.

3. **Suggested Answers**

After announcement of results, the suggested answers of the questions asked in that particular attempt are issued by the Board of studies.

4. **Revision Test Papers**

For every examination, Board of studies comes out with Revision Test Papers (RTP) meant for that particular attempt. However, in Accounts, you may refer RTPs of past few attempts.

5. **Mock Test Papers**

Mock Test Papers are also issued by the Board of Studies time to time. These mock test papers are based on the pattern of the question paper of the past examination.

Now, after knowing the various knowledge inputs provided by the Board of Studies, you should plan your studies accordingly. As stated earlier that all the course-ware mentioned above is not provided to you at the same time, hence one can comprehend that the objective of each knowledge input provided is different and requires your practice of the same, at different stage of your study.

How to study?

There is a very popular saying that if you fail to plan then you plans to fail. Planning is one of the essential elements for studying a subject of professional course. By planning, here we mean time management for subject as a whole and individually as well for each and every chapter. We would like to state that for the paper of accounting, one needs at least three rounds of study.

Advanced Accounting examination paper is purely practical based. Therefore, one has to do written practice of good number of questions on each topic. So, at the time of planning the study for accounting you should keep into mind the written practice of practical questions also. Considering the practical nature of the paper, start your studies from the day you receive the course material.

Keeping in mind the quantum of the syllabus, it is suggested that you should study one to two hours a day. By doing so, you will be able to manage first round of complete study and two rounds of revision well before time. Your first round of study should be completed well in advance that is at least three months before your exam. However, your planning should be based on the availability of time and the contents of the subject.

Your second round of study i.e. your first revision should be over before one month of your exam. Your second revision should be in the last month before exam so that you will be in the position to remember all the concepts. These three rounds of study will help in boosting the confidence level for the subject and will make you mentally prepared to appear in the examination.

Schedule

First round of study

Similar to the paper of Accounting, the syllabus of 'Advanced Accounting' also covers Accounting Standards as well as other topics, so here also, your planning should be divided in two parts namely-

1. Accounting Standards
2. Other chapters of the course curriculum.

Every day when you start your study first go through the concepts which you have read last day then start learning new concepts. Remember, out of sight, out of mind. Ideally your first study should be within 24 hours of initial reading, the second within 1 week of reading.

In Paper 1 ‘Accounting’ at Intermediate (IPC) Course Group I level, we already had chapters on Partnership firm and Company accounts which dealt with some of the aspects of such form of businesses. Like in partnership, aspects of admission, retirement or death of a partner have been dealt with and the topics of company’s accounts dealt with the issue of bonus shares, amalgamation, internal reconstruction etc.

The paper of ‘Advanced Accounting’ covers some more aspects of partnership firm and company accounts. Therefore, we in this paper recommend you to take these topics first as you are familiar with the accounting treatment followed in such types of businesses and will be in a position to grasp quickly the accounting treatment to be done for other aspects covered in this paper. However, considering the importance of these topics, unit on amalgamation and internal reconstruction has been included in this paper also.

For other topics, you may decide, at your convenience as to which topic should be taken up next and in what sequence. However, for this paper, we suggest you to study accounting standards at the end as we do not have any chapter which is specifically based on the provisions of accounting standards though accounting standards may apply in some situations like for valuation of investments of banks you may have to apply the provisions of AS 13 if nothing is specified in the Banking Regulations or the RBI Act in this regard.

Again in this paper also, we would like to re-iterate that for accounting standards, study the explanation given in chapter 2 first and then study the bare text of the accounting standard given as an appendix at the end, after chapter 9 of the study material. Following this procedure will help you in-depth understanding of the underlying concepts of accounting standards specified in the syllabus and the manner in which it is interpreted and should be interpreted.

Use of BoS Knowledge inputs in a systematic pattern

Step 1 Study material

To lay a strong foundation of the understanding of any particular topic, study material explains the concepts of each and every topic in detail with adequate illustrations. Study the underlying concepts and accounting treatment specified therein analytically before proceeding towards illustrations. Keep questioning yourself until you are absolutely clear on the topic. Solve the illustrations after understanding the topic.

Step 2 Practice Manual

After solving the illustrations given in the study material, solve the questions given in the practice manual. Practice Manual is highly useful for the students appearing in the examination as it includes questions from past examinations which would facilitate in thorough understanding of the chapters explained in the study material. In Advanced Accounting paper, it is very necessary that one should practice a good number of questions dealing with different adjustments. Practice Manual will help serve this purpose. Your first round of study should cover both Study Material and Practice Manual.

Second round of study

Step 3 Suggested answers

Your second round of study i.e. your first revision should cover practice of suggested answers of recent two to three examinations. Suggested answers of past few examinations give you an idea of what type of questions are asked in the examination and how to solve and present the solution for such questions in the examination. Solving the question paper in the examination situation will help you, not only in time management but will also give you the confidence to attempt different types of questions in the examination.

Step 4 Revision Test Papers (RTP)

After you complete revision of whole syllabus at least once, you should solve the questions given in the RTP. For every examination, Board of Studies comes out with a Revision Test Paper. Revision Test Paper is issued for every attempt containing a fresh set of questions which will help you to evaluate your preparation level. RTP of Advanced Accounting is divided into two parts namely Part I: Recent amendments, Notifications and Announcements which are relevant for that particular examination and are not given in the study material or were not applicable in the immediate past examination. You will be able to know all such relevant information applicable for the exam at one place. Part II carries questions and answers for your practice. In Advanced Accounting, questions on each topic are given with full solution to enable you to get an insight on how to present the solutions in an orderly manner. In Advanced Accounting paper, RTP of past few attempts can also be referred subject to amendments for which you have to refer the latest Study Material and RTP.

Third round of study

Step 5 Mock Test Papers

After second revision of the complete syllabus, you may assess your preparation by taking mock tests conducted by various branches at their end. Also Mock test papers are hosted on the institute's website www.icai.org which you may download and solve within a time period of three hours.

Important points to be kept in mind

1. Preparation of notes

Prepare concise notes in the first round of study itself. Your notes should be prepared in a manner, which supplements your understanding of the concept and the illustrations you have solved. You may either make a separate copy where you write down the important concepts of the chapter or can underline the important concepts in the book itself and read those underlined portion at the time of revision. You should also shortlist the illustrations to be revised again in your second and third round of study. Short listing of illustrations should be based on the difficulty you faced while solving the question. Besides preparation of important points of the topic (which will help you to recapitulate the whole concepts), a summary of tricky points and adjustments gathered from the practice of various good illustrations may also be prepared which will help in grasping the intricate practical aspects. Such tricky points or adjustments should be cross linked with the concerned illustration number so that at the time of revision you not only study the accounting treatment but also refer the whole solution again. These notes may also be accompanied by the proforma of relevant accounts and diagrams so that at the later stages of preparation, the conceptual knowledge underlying different topics may be gained within minimum time and efforts without going through a number of books again.

2. Use of proper and prescribed format for presentation of accounts

There are some chapters which require the solution or financial statements to be presented in particular format. You should make it a practice to adopt the prescribed formats while presenting the accounts of particular entities. For example: Financial Statements of companies should be in the format prescribed in the Schedule III to the Companies Act, 2013.

3. Recapitulation of previously read topics

The chapter of Partnership accounts was also there in the paper of 'Fundamentals of Accounting' at CPT level. Therefore, here at Intermediate (IPC) Course level, you are required to whet your skills on this topic. Also the concepts and provisions read at CPT level lays down the foundation for studying and understanding the topics specified at the Intermediate (IPC) Course level. For example, concept of revenue and capital receipt and expenditure is applied in every topic while preparing the financial statements of an entity. Similarly, valuation of inventory, accounting for depreciation etc. are some of the topics the concepts of which are applied in general to all entities.

4. Keep yourself continuously updated

We at Board of studies endeavor to update you with the latest amendments or notifications as and when they are issued. One of the sections in the Students' Journal is on 'Academic Update' which contains recent amendments in accounting also. You should be in a habit to read this continuously as it will help you in avoiding last moment pressure to acquaint yourself with all the relevant amendments. Also list of publications comprising of all relevant accounting standards and guidance notes are published well in time in the Students' Journal and the institute's website to apprise you with the applicability part of the same in the particular examination.

5. Keep in mind the Inter-linking of various topics

The provisions of accounting standards have to be kept in mind and applied while studying the related chapter based on the particular accounting standard. If your concepts are clear relating to a particular standard, you should not face any problem in applying the same to solve problems in an inter-connected chapter. Sometimes even though the chapter may not directly relate to an accounting standard, it may contain adjustments involving application of one or more standards.

Tips for examination

Following are accounting related examination tips which you should keep in mind at the time of appearing for the examination:

1. Use of proper formats

Certain statutes prescribe specific formats for presentation of the accounts. You should take care of the same at the time of solving the questions in the exam. Accounts presented in the prescribed manner will help you in scoring due marks.

2. Adequate Working Notes

In accounts, your solution is generally divided in two parts viz- main solution and working notes. Working notes form part of your solution and carries marks. Therefore, it is advised that calculations made on your calculator should also be written in your answer sheet as working note, wherever required, neatly and precisely. Also your working note should be cross referenced with the figure used in the main solution so that examiner can easily understand that how you have arrived at the particular figure.

3. Answer the questions with due emphasis on the provisions of Accounting Standards

Support your answers/conclusions with proper reasoning. Answers for questions based on accounting standards should be supported with provisions of that accounting standard rather than a mere common sense or guess work. It is not required to quote paragraph number of Accounting standard but you are expected to quote accounting standard number along with the name of the standard. However, if you state, paragraph number of accounting standard, then it will add value to the solution and will also help create a good impression in the mind of the examiner. You should quote number of accounting standard or name only when you are sure. It is better not to quote than to misquote the accounting standard number.

4. State the assumption clearly

In case a question leaves room for making an assumption and there is a possibility of more than one assumption, it is important to clearly state the assumption you have taken and solve the question accordingly.

Happy Reading and Best Wishes!

SYLLABUS

GROUP II
PAPER 5: ADVANCED ACCOUNTING

(One paper – Three hours – 100 Marks)

Level of Knowledge: Working Knowledge

Objectives:

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

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

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

Contents :

1. Framework for Preparation and Presentation of Financial Statements

2. Accounting Standards

Working knowledge of:

AS 4 : Contingencies and Events occurring after the Balance Sheet Date

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

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

AS 12 : Accounting for Government Grants

AS 16 : Borrowing Costs

AS 19 : Leases

AS 20 : Earnings Per Share

AS 26 : Intangible Assets

AS 29 : Provisions, Contingent Liabilities and Contingent Assets.

3. **Advanced Issues in Partnership Accounts and Issues related to accounting in Limited Liability Partnerships**

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

4. **Company Accounts**

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

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

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

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

5. **Accounting for Special Transactions**

   Departmental and branch accounts including foreign branches

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

CONTENTS

DETAILED CONTENTS : MODULE – 1

1

Framework for Preparation and Presentation of Financial Statements

Learning Objectives

After studying this chapter, you will be able to:

- Understand the meaning and significance of Framework for the Preparation and Presentation of Financial Statements.
- Learn objectives of Financial Statements.
- Understand qualitative characteristics of Financial Statements.
- Comprehend recognition and measurement of elements of Financial Statements.
- Know concepts of capital, capital maintenance and determination of profit.

1. Introduction

The development of accounting standards or any other accounting guidelines need a foundation of underlying principles. The Accounting Standards Board (ASB) of the ICAI issued framework in July, 2000 which provides the fundamental basis for development of new standards as also for review of existing standards. The principal areas covered by the framework are as follows:

(a) Components of financial statements;

(b) Objectives of financial statements;

(c) Assumptions underlying financial statements;

(d) Qualitative characteristics of financial statements;

(e) Elements of financial statements;

(f) Criteria for recognition of elements in financial statements;

(g) Principles of measurement of financial elements;

(h) Concepts of Capital and Capital Maintenance.

2. Purpose of the Framework

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

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

(b) Accounting Standard Board (ASB) in its task of development and review of accounting standards.

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

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

(e) Users in interpretation of financial statements.

3. Status and Scope of the Framework

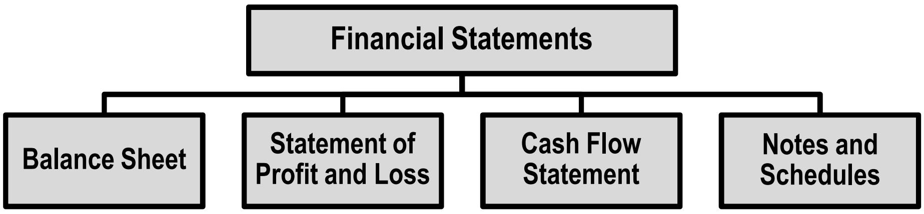
The framework applies to general-purpose financial statements (hereafter referred to as 'financial statements' usually prepared annually for external users, by all commercial, industrial and business enterprises, whether in public or private sector. The special purpose financial reports, for example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

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

4. Components of Financial Statements

A complete set of financial statements normally consists of a Balance Sheet, a Statement of Profit and Loss and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements.

All parts of financial statements are interrelated because they reflect different aspects of same transactions or other events. Although each statement provides information that is different from each other, none in isolation is likely to serve any single purpose nor can any one provide all information needed by a user.



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

Balance Sheet portrays value of economic resources controlled by an enterprise. It also provides information about liquidity and solvency of an enterprise which is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due.

Statement of Profit and Loss presents the result of operations of an enterprise for an accounting period.

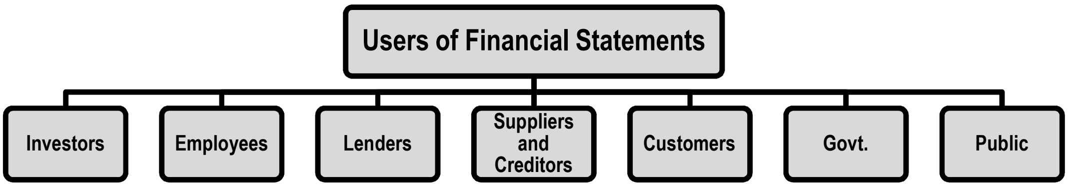
Cash Flow Statement shows the way an enterprise has generated cash and the way they have been used in an accounting period.

Notes and Schedules present supplementary information explaining different items of financial statements. They may include disclosures about the risks and uncertainties affecting the enterprise and such items as disclosure of accounting policies, segmental reports, report on operations in the process of discontinuation and so on.

5. Objectives and Users of Financial Statements

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

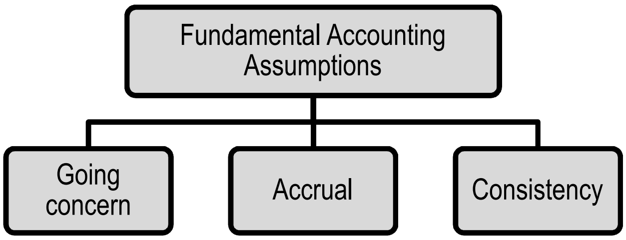
The framework identifies seven broad groups of users of financial statements.



All users of financial statements expect the statements to provide useful information needed to make economic decisions. The financial statements provide information to suit the common needs of most users. However, they cannot and do not intend to provide all information that may be needed, e.g. they do not provide non-financial data even if they may be relevant for making decisions.

6. Fundamental Accounting Assumptions

As per the framework, there are three fundamental accounting assumptions:



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

If nothing has been written about the fundamental accounting assumption in the financial statements then it is assumed that they have already been *followed in their preparation of financial statements*.

However, if any of the above mentioned fundamental accounting assumption is not followed then this fact should be specifically disclosed.

Let us discuss these assumptions in detail.

(a) Going Concern: Financial statements are normally prepared on the assumption that an enterprise will continue in operation in the foreseeable future and neither there is intention, nor there is need to materially curtail the scale of operations.

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

Example 1

Balance sheet of a trader on 31st March, 2012 is given below:

Liabilities	₹	*Assets*	₹
Capital	*60,000*	*Fixed Assets*	*65,000*
Profit and Loss Account	*25,000*	*Stock*	*30,000*
10% Loan	*35,000*	*Trade receivables*	*20,000*
Trade payables	*10,000*	*Deferred costs*	*10,000*
		Bank	*5,000*
	1,30,000		*1,30,000*

Additional information:

(a) The remaining life of fixed assets is 5 years. The pattern of use of the asset is even. The net realisable value of fixed assets on 31.03.13 was ₹ 60,000.

(b) The trader's purchases and sales in 2012-13 amounted to ₹ 4 lakh and ₹ 4.5 lakh respectively.

(c) The cost and net realisable value of stock on 31.03.13 were ₹ 32,000 and ₹ 40,000 respectively.

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

(e) Deferred cost is amortised equally over 4 years.

(f) Debtors on 31.03.13 is ₹ 25,000, of which ₹ 2,000 is doubtful. Collection of another ₹ 4,000 depends on successful re-installation of certain product supplied to the customer.

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

(h) Cash balance on 31.03.13 is ₹ 37,100.

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

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

Profit and Loss Account for the year ended 31st March, 2013

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

Balance Sheet as at 31st March, 2013

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

(b) Accrual Basis: Under this basis of accounting, transactions are recognised as soon as they occur, whether or not cash or cash equivalent is actually received or paid. Accrual basis ensures better matching between revenue and cost and profit/loss obtained on this basis reflects activities of the enterprise during an accounting period, rather than cash flows generated by it. Hence, accrual basis is a more logical approach for profit determination compared to cash basis of accounting.

Accrual basis exposes an enterprise to the risk of recognising an income before actual receipt. The accrual basis can therefore overstate the divisible profits and dividend decisions based on such overstated profit lead to erosion of capital. For this reason, accounting standards require that no revenue should be recognised unless the amount of consideration and actual realisation of the consideration is reasonably certain. Despite the possibility of distribution of profit not actually earned, accrual basis of accounting is generally followed because of its logical superiority over cash basis of accounting. Section 209(3)(b) of the Companies Act makes it mandatory for companies to maintain accounts on accrual basis only. It is not necessary to expressly state that accrual basis of accounting has been followed in preparation of a financial statement. In case, any income/expense is recognised on cash basis, the fact should be stated.

Example 2

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

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

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

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

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

Cash basis of accounting

Cash purchase of article B and cash sale of article A is recognised in period 1 while purchase of article A on payment and sale of article B on receipt is recognised in period 2.

Profit and Loss Account

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

Accrual basis of accounting

Credit purchase of article A and cash purchase of article B and cash sale of article A and credit sale of article B is recognised in period 1 only.

Profit and Loss Account

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

(c) Consistency: The principle of consistency refers to the practice of using same accounting policies for similar transactions in all accounting periods. The consistency improves comparability of financial statements through time. An accounting policy can be changed if the change is required

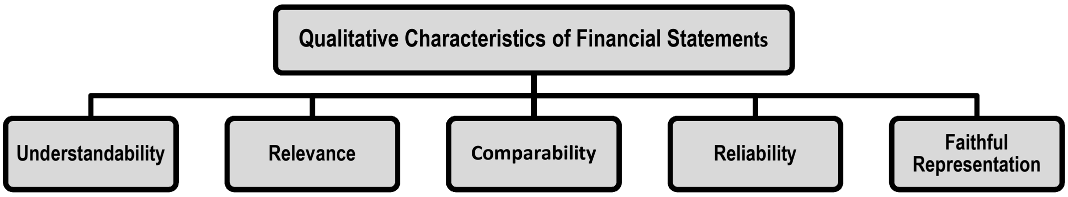
(i) by a statute or

(ii) by an accounting standard or

(iii) for more appropriate presentation of financial statements.

7. Qualitative Characteristics

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



These attributes can be explained as:

1. **Understandability:** The financial statements should present information in a manner as to be readily understandable by the users with reasonable knowledge of business and economic activities. It is not right to think that more information one discloses the better it is. A mass of irrelevant information creates confusion and can be even more harmful than non-disclosure.

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

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

   (a) Transactions and events reported are faithfully represented.

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

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

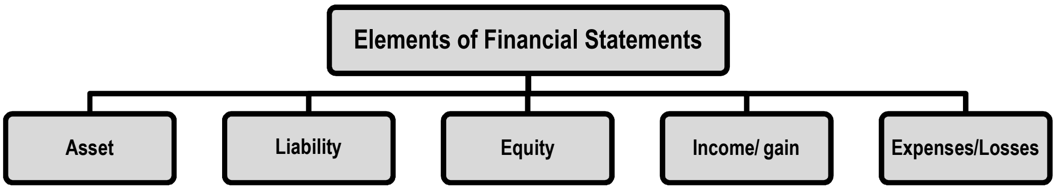
   (d) Prudence is exercised in reporting uncertain outcome of transactions or events.

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

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

8. Elements of Financial Statements

The framework classifies items of financial statements in five broad groups depending on their economic characteristics.



Gains and losses differ from income and expenses in the sense that they do not arise in the ordinary course of business. Except for the way they arise, economic characteristics of gains are same as income and those of losses are same as expenses. For these reasons, gains and losses are not recognised as separate elements of financial statements.

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

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

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

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

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

Let us discuss each element of financial statement in detail.

1. Asset: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. The following points must be considered while recognizing an asset:

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

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

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

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

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

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

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

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

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

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

Example 3

A Ltd. has entered into a binding agreement with P Ltd. to buy a custom-made machine ₹ 40,000. At the end of 2012-13, before delivery of the machine, A Ltd. had to change its method of production. The new method will not require the machine ordered and shall be scrapped after delivery. The expected scrap value is nil.

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

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

		₹	₹
Profit and Loss Account *(Loss due to change in production method)*	*Dr.*	*40,000*	
To P Ltd.			*40,000*

3. Equity: Equity is defined as residual interest in the assets of an enterprise after deducting all its liabilities. It is important to avoid mixing up liabilities with equity. Equity is the excess of aggregate assets of an enterprise over its aggregate liabilities. In other words, *equity represents owners' claim consisting of items like capital and reserves*, which are clearly distinct from liabilities, i.e. claims of parties other than owners. The value of equity may change either through contribution from / distribution to equity participants or due to income earned /expenses incurred.

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

Income earned is always associated with either increase of asset or reduction of liability. This means, no income can be recognised unless the corresponding increase of asset or decrease of liability can be recognised. For example, a bank does not recognise interest earned on non-performing assets because the corresponding asset (increase in advances) cannot be recognised, as flow of economic benefit to the bank beyond current accounting period is not probable. Thus

Balance sheet of an enterprise can be written in form of:

A – L = E.

Where:

A = Aggregate value of asset

L = Aggregate value of liabilities

E = Aggregate value of equity

Example 4

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

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

(a) Introduced capital ₹ 20,000.

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

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

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

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

This example given explains the definition of income. The equity increased by ₹ 29,000 during the accounting period, due to (i) Capital introduction ₹ 20,000 and (ii) Income earned ₹ 9,000 (Income from investment + Discount earned). Incomes are therefore increases in equity without introduction of capital.

Also note that income earned is accompanied by either increase of asset (Cash received as investment income) or by decrease of liability (Discount earned).

5. Expense: An expense is decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants. The definition of expenses encompasses expenses that arise in the ordinary course of activities of the enterprise, e.g. wages paid. Losses may or may not arise in the ordinary course of activity of the enterprise, e.g. loss on disposal of fixed assets. Losses are separately showed in the statement of profit and loss because this knowledge is useful in assessing performance of the enterprise.

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

Where economic benefits are expected to arise over several accounting periods, expenses are recognised in the profit and loss statement on the basis of systematic and rational allocation procedures. The obvious example is that of depreciation.

An expense is recognised immediately in the profit and loss statement when it does not meet or ceases to meet the definition of asset or when no future economic benefit is expected. An expense is also recognised in the profit and loss statement when a liability is incurred without recognition of an asset, as is the case when a liability under a product warranty arises.

Example *5*

Continuing with the example 4 given above, suppose the trader had the following further transactions during the period:

(a) Wages paid ₹ 2,000.

(b) Rent outstanding ₹ 1,000.

(c) Drawings ₹ 4,000.

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

Transactions	*Assets ₹ lakh*	–	*Liabilities ₹ lakh*	=	*Equity ₹ lakh*
Opening	*5.00*	–	*2.00*	=	*3.00*

(a)	*Capital introduced*	*5.20*	*–*	*2.00*	*=*	*3.20*
(b)	*Income from investments*	*5.28*	*–*	*2.00*	*=*	*3.28*
(c)	*Settlement of liability*	*4.98*	*–*	*1.69*	*=*	*3.29*
(d)	*Wages paid*	*4.96*	*–*	*1.69*	*=*	*3.27*
(e)	*Rent Outstanding*	*4.96*	*–*	*1.70*	*=*	*3.26*
(f)	*Drawings*	*4.92*	*–*	*1.70*	*=*	*3.22*

The example given above explains the definition of expense. The equity decreased by ₹ 7,000 from ₹ 3.29 lakh to ₹ 3.22 lakh due to (i) Drawings ₹ 4,000 and (ii) Expenses incurred ₹ 3,000 (Wages paid + Rent).

Expenses are therefore decreases in equity without drawings. Also note that expenses incurred is accompanied by either decrease of asset (Cash paid for wages) or by increase in liability (Rent outstanding).

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

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

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

Capital Introduced = C

Drawings = D

Income = I

Expenses = E

$CE = OE + C + (I – E) – D$

Or $CE = OE + C + Profit – D$

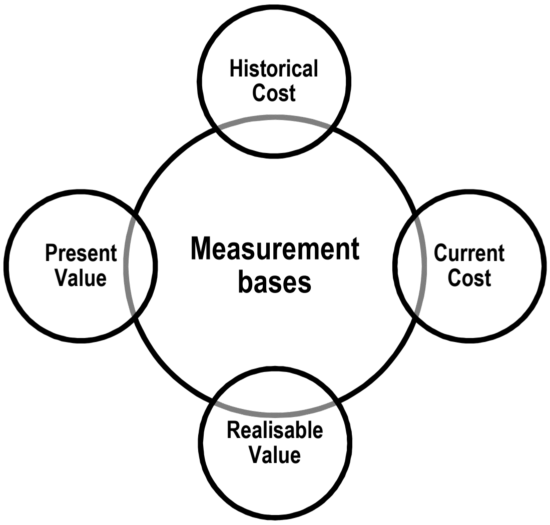
Or $Profit = CE – OE – C + D$

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

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

9. Measurement of Elements of Financial Statements

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



In preparation of financial statements, all or any of the measurement basis can be used in varying combinations to assign money values to financial items.

A brief explanation of each measurement basis is as follows:

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

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

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

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

Example 6

Mr. X purchased a machine on 1st January, 2008 at ₹ 7,00,000. As per historical cost basis, he has to record it at ₹ 7,00,000 i.e. the acquisition price. As on 1.1.2013, Mr. X found that it would cost ₹ 25,00,000 to purchase that machine. Take also that Mr. X took loan from a bank as on 2008 ₹ 5,00,000 @ 18% p.a repayable at the end of 15^{th} year together with interest.

As per historical cost, the liability is recorded at₹ 5,00,000 at the amount or proceeds received in exchange for obligation and asset is recorded at ₹ 7,00,000.

2. Current Cost: Current cost gives an alternative measurement basis. Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Paragraph 80 of the Conceptual framework provides that revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves.

Example 7

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

		₹	₹
Machinery A/c	*Dr.*	*5,00,000*	
To Deferred Payment Obligation			*4,90,000*
To Revaluation Reserves			*10,000*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 8

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

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

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

Net selling price = ₹ 35,000

The present value of the asset is ₹ 37,900, which is called its recoverable value. It is obviously not appropriate to carry any asset at a value higher than its recoverable value. Thus the asset is currently overstated by ₹ 2,100 (₹ 40,000 – ₹ 37,900).

10. Capital Maintenance

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

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

Where: Profit = P

Opening Assets = OA and Opening Liabilities = OL

Closing Assets = CA and Closing Liabilities = CL

Introduction of capital = C and Drawings / Dividends = D

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

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

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

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

Financial capital maintenance at historical cost: Under this convention, opening and closing assets are stated at respective historical costs to ascertain opening and closing equity. If retained profit is greater than zero, the capital is said to be maintained at historical costs. This means the business will have enough funds to replace its assets at historical costs. This is quite right as long as prices do not rise.

Example 9

A trader commenced business on 01/01/2012 with ₹ 12,000 represented by 6,000 units of a certain product at ₹ 2 per unit. During the year 2012 he sold these units at ₹ 3 per unit and had withdrawn ₹ 6,000. Thus:

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

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

Retained Profit = ₹ 12,000 – ₹ 12,000 = Nil

The trader can start year 2013 by purchasing 6,000 units at ₹ 2 per unit once again for selling them at ₹ 3 per unit. The whole process can repeat endlessly if there is no change in purchase price of the product.

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

Example 10

In the previous example (Example 9), suppose that the average price indices at the beginning and at the end of year are 100 and 120 respectively.

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

Opening equity at closing price = (₹ 12,000 / 100) x 120 = ₹ 14,400 (6,000 x ₹ 2.40)

Closing Equity at closing price

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

Retained Profit = ₹ 12,000 – ₹ 14,400 = (-) ₹ 2,400

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

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

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

Example 11 *(Physical capital maintenance)*

In the previous example(Example 9) suppose that the price of the product at the end of year is ₹ 2.50 per unit. In other words, the specific price index applicable to the product is 125.

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

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

Opening equity at closing current costs = ₹ 15,000

Closing equity at closing current costs = ₹ 12,000

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

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

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

Capital maintenance can be computed under all three bases as shown below:

Financial Capital Maintenance at historical costs

	₹	₹
Closing capital (At historical cost)		*12,000*
Less: Capital to be maintained		
Opening capital (At historical cost)	*12,000*	
Introduction (At historical cost)	*Nil*	*(12,000)*
Retained profit		*Nil*

Financial Capital Maintenance at current purchasing power

	₹	₹
Closing capital (At closing price)		*12,000*
Less: Capital to be maintained		

Opening capital (At closing price)	*14,400*	
Introduction (At closing price)	*Nil*	*(14,400)*
Retained profit		*(2,400)*

Physical Capital Maintenance

	₹	₹
Closing capital (At current cost)		*12,000*
Less: Capital to be maintained		
Opening capital (At current cost)	*15,000*	
Introduction (At current cost)	*Nil*	*(15,000)*
Retained profit		*(3,000)*

Summary

- **Components of Financial Statements**

Balance sheet	Portrays value of economics resources controlled by an enterprise.
Statement of Profit and loss	Presents the results of operations of an enterprise.
Cash flow statement	Shows the way an enterprise generates cash and uses it.
Notes and schedules	Presents supplementary information explaining different items

- **Users of Financial Statements**

Investors	Analysis of performance, profitability, financial position of Co.
Employees	Knowledge of stability, continuity, growth.
Suppliers, creditors	Determination of credit worthiness.
Customers	Analysis of stability, profitability.
Govt.	Evaluation of entity's performance and contribution to social objectives.

- **Fundamental Accounting Assumptions**

Accrual	Transactions are recognized as and when they occur,

	without considering receipt /payment of cash.
Going concern	Enterprise will continue in operation in foreseeable future and will not liquidate.
Consistency	Using same accounting policies for similar transactions in all accounting periods.

- **Qualitative Characteristics of Financial Statements**

Understandability	Information presented in financial statements should be readily understandable by the users with reasonable knowledge of business and economic activities.
Relevance	Financial statements should contain relevant information only. Information, which is likely to influence the economic decisions by the users, is called relevant.
Reliability	Information must be reliable; that is to say, they must be free from material error and bias.
Comparability	Financial statements should permit both inter-firm and intra-firm comparison.
True and Fair view	Financial statements should show a true and fair view of the performance, financial position and cash flows of an enterprise.

- **Elements of Financial Statements**

Asset	Resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise
Liability	Present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow of a resource embodying economic benefits.
Equity	Residual interest in the assets of an enterprise after deducting all its liabilities.
Income/gain	Increase in economic benefits during the accounting period in the form of inflows or enhancement of assets or decreases in liabilities that result in increase in equity other than those relating to contributions from equity participants
Expense/loss	Decrease in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decrease in equity other than those relating to distributions to equity participants.

- **Measurement of Elements in Financial Statements**

Historical cost	Acquisition price
Current Cost	Assets are carried out at the amount of cash or cash equivalent that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
Realisable (Settlement) Value	For assets, amount currently realisable on sale of the asset in an orderly disposal. For liabilities, this is the undiscounted amount expected to be paid on settlement of liability in the normal course of business.
Present Value	Assets are carried at present value of future net cash flows generated by the concerned assets in the normal course of business. Liabilities are carried at present value of future net cash flows that are expected to be required to settle the liability in the normal course of business.

- **Capital Maintenance**

Financial capital maintenance	
At historical cost	Opening and closing assets are stated at historical costs.
At current purchasing power	Restatement at closing prices using average price indices.
Physical capital maintenance	Restatement at closing prices using specific price indices.

2

Accounting Standards

Learning objectives

After studying this chapter, you will be able to:

- Understand the provisions of the Accounting Standards specified in the syllabus.
- Solve the practical problems based on application of Accounting Standards.

1. Introduction

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

2. Overview

2.1 AS 4: Contingencies and Events Occurring After the Balance Sheet Date

Accounting Standard 4 'Contingencies* and Events Occurring after the Balance Sheet Date' covers accounting treatment of

---

* *Pursuant to AS 29, "Provisions, Contingent Liabilities and Contingent Assets' becoming mandatory in respect of accounting periods commencing on or after 1.4.2004, all paragraphs of this standard that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. For example, impairment of receivables (i.e. provision for bad and doubtful debts) would continue to be covered by AS 4. An Exposure Draft has recently been issued by the ICAI on Limited Revision to AS 4 "Events occurring After the Balance Sheet Date". However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

(i) contingencies and

(ii) events occurring after the balance sheet date.

The ASB has issued an announcement on 'Applicability of AS 4 to impairment of assets not covered by present Indian Accounting Standards'. In the announcement, ASB has clearly stated that as per AS 29 'provisions' are liabilities which can be measured only by using a substantial degree of estimation. It further says that 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. Out of it, depreciation is dealt with as per AS 6 and impairment is dealt with as per AS 28. However, the impairment of financial assets like receivable (provision for bad and doubtful debts) is not dealt with by any of the existing mandatory standards. In view of this, it has been decided that the paragraphs of AS 4 which deal with contingencies would remain operational to the extent they cover the impairment of assets like receivables (i.e. provision for bad and doubtful debts).

Definitions

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

- **A *contingency*** is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.
- ***Events occurring after the balance sheet date*** are those significant events, both favourable and unfavorable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

  Two types of events can be identified:

  (a) those which provide further evidence of conditions that existed at the balance sheet date; and

  (b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Events Occurring after Balance Sheet Date

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

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

The events occurring after the balance sheets can be reported either by

(i) making appropriate adjustments in the financial statements or

(ii) through report of the approving authority*, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities.

Adjusting Events

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

Disclosure

- The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.
- If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote. If a reliable estimate of the financial effect cannot be made, this fact is disclosed.
- When the events occurring after the balance sheet date are disclosed in the report of the approving authority*, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Example 1

A Ltd., whose accounting year ends on 31/03/2013, agreed in principle to sell a plot of land on 18/03/2013 at a price to be determined by an independent valuer. Pending the agreement for sale and due to non-receipt of valuers report, the sale of the land could not be completed up to 31/03/13. The company received the report on April 7, 2013 and the agreement was signed on April 10, 2013. The financial statements for 2012-13 were approved by the board on May 12, 2013.

---

* *To promote transparency, Exposure Draft has recently been issued by the ICAI on Limited Revision to AS 4 "Events occurring After the Balance Sheet Date". According to this Limited Revision, these events should be disclosed in the financial statements instead of in the report of the approving authority. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

The sale of land is an event occurring after the balance sheet date. Also, the condition, which led to the sell, existed on the balance sheet date. The signing of the agreement provides further evidence as to the condition that existed on the balance sheet date. The sale of land after the balance sheet date is therefore an adjusting event, which means the sale transaction should be recorded in books of A Ltd. for the purpose of its financial statements for 2012-13.

Non-adjusting events

- Events after balance sheet date may result from conditions arising subsequent to the balance sheet date. Such events do not justify change in the reported values of assets, liabilities, expenses, income or equity.
- Such events, if they represent material changes and commitments affecting financial position of the enterprise, should be disclosed in the report of approving authority*, i.e. Directors' Report in case of companies and report of corresponding approving authority in case of other entities.
- For example, an announcement after balance sheet date but before approval of financial statement, of a formal plan to discontinue an operation does not justify adjustment of financial statement of the accounting period already over, but is indicative of material change in future. Such events should be disclosed in the report of approving authority* (Paragraph 15).
- As per paragraph 17 of the standard, in reporting non-adjusting events, the directors (or other approving authority, as the case may be) should state the nature of the event along with their estimate of financial effect of the event. Where estimate of financial effect cannot be made, the report should state the fact that such an estimate cannot be made.

Dividends

The directors may propose dividends after balance sheet date for the obvious reason that no dividend can be proposed till the year is over and profit is ascertained. The dividends proposed by the directors however, do not reflect any condition existing on the balance sheet date. The provision for proposed dividends is not required to be disclosed in Schedule III to the Companies Act, 2013. Accordingly, to harmonize the requirements of AS 4 in line with the requirements of the Schedule III to the Companies Act, 2013, an Exposure Draft has been issued by the ICAI in year 2012 on Limited Revision to AS 4 "Events occurring After the Balance Sheet Date". According to this Limited Revision, paragraphs 8.5 and 14 of the Standard have been modified and proposed dividends is not treated as adjusting event (as was earlier done before issuance of this Limited Revision). If an entity declares dividends to shareholders after the balance sheet date, the entity should not recognise those dividends as

* *To promote transparency, Exposure Draft has recently been issued by the ICAI on Limited Revision to AS 4 "Events occurring After the Balance Sheet Date". According to this Limited Revision, these events should be disclosed in the financial statements instead of in the report of the approving authority. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

a liability at the balance sheet date. Such dividends are disclosed in the notes. However, this limited revision has not yet been notified by the Government.

At present, the proposed dividends are shown under the short term provision as per the Guidance Note.

Example 2

An earthquake destroyed a major warehouse of C Ltd. on April 20, 2013. The last accounting year of the company ended on 31/03/13 and the financial statements for the year were approved on May 8, 2013. The destruction of warehouse is a significant event occurring after the balance sheet date, but since the earthquake did not exist on the balance sheet date, the destruction by earthquake is a non-adjusting event. The value of property lost by earthquake therefore need not be recognised in financial statement of 2012-13

The Report of the Directors[*] for 2012-13 should disclose the fact of earthquake together with an estimate of loss on earthquake. If no estimate of loss can be made, the report should state that loss on earthquake could not be estimated.

Example 3

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

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

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

---

[*] *These events, however, are disclosed in the financial statements instead of report of directors as per Exposure Draft on Limited Revision to AS 4. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

Exception to rule:

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

Suppose a fire occurred in the factory and office premises of an enterprise after 31/03/13 but before approval of financial statement of 2012-13. The loss on fire is of such a magnitude that it is not reasonable to expect the enterprise to start operations again. Since the fire occurred after 31/03/13, the loss on fire is not a result of any condition existing on 31/03/13. Yet, the loss should be recognised in the statement of profit and loss for 2012-13 and the assets lost should be written off from the balance sheet dated 31/03/13.

Illustration 1

In X Co. Ltd., theft of cash of ₹ 5 lakhs by the cashier in January, 2013 was detected only in May, 2013. The accounts of the company were not yet approved by the Board of Directors of the company.

Whether the theft of cash has to be adjusted in the accounts of the company for the year ended 31.3.2013. Decide.

Solution

As per paragraph 13 of AS 4 (revised) 'Contingencies and Events occurring after the Balance Sheet Date', an event occurring after the balance sheet date may require adjustment to the reported values of assets, liabilities, expenses or incomes.

If a fraud of the accounting period is detected after the balance sheet date but before approval of the financial statements, it is necessary to recognize the loss amounting ₹ 5,00,000 and adjust the accounts of the company for the year ended 31st March, 2013.

Illustration 2

An earthquake destroyed a major warehouse of ACO Ltd. on 20.5.2012. The accounting year of the company ended on 31.3.2012. The accounts were approved on 30.6.2012. The loss from earthquake is estimated at ₹ 30 lakhs. State with reasons, whether the loss due to earthquake is an adjusting or non-adjusting event and how the fact of loss is to be disclosed by the company.

Solution

Para 8.3 of AS 4 "Contingencies and Events Occurring after the Balance Sheet Date", states that adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. The destruction of warehouse due to earthquake did not exist on the balance sheet date i.e. 31.3.2012. Therefore, loss occurred due to earthquake is not to be recognised in the financial year 2011-2012.

However, according to para 8.6 of the standard, unusual changes affecting the existence or substratum of the enterprise after the balance sheet date may indicate a need to consider the use of fundamental accounting assumption of going concern in the preparation of the financial statements. As per the information given in the question, the earthquake has caused major destruction; therefore fundamental accounting assumption of going concern is called upon. Hence, the fact of earthquake together with an estimated loss of ₹ 30 lakhs should be disclosed in the Report of the Directors* for the financial year 2011-2012.

Illustration 3

A company has filed a legal suit against the debtor from whom ₹ 15 lakh is recoverable as on 31.3.2012. The chances of recovery by way of legal suit are not good as per legal opinion given by the counsel in April, 2012. Can the company provide for full amount of ₹ 15 lakhs as provision for doubtful debts? Discuss in detail.

Solution

As per para 13 of AS 4 "Contingencies and Events Occurring After the Balance Sheet Date", assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions existing at the balance sheet date. In the given case, company should make the provision for doubtful debts, as legal suit has been filed on 31st March, 2012 and the chances of recovery from the suit are not good. Though, the actual result of legal suit will be known in future yet situation of non-recovery from the debtors exists before finalisation of financial statements. Therefore, provision for doubtful debts should be made for the year ended on 31st March, 2012.

Illustration 4

During the year 2012-2013, Raj Ltd. was sued by a competitor for ₹ 15 lakhs for infringement of a trademark. Based on the advice of the company's legal counsel, Raj Ltd. provided for a sum of ₹ 10 lakhs in its financial statements for the year ended 31st March, 2013. On 18th May, 2013, the Court decided in favour of the party alleging infringement of the trademark and ordered Raj Ltd. to pay the aggrieved party a sum of ₹ 14 lakhs. The financial statements were prepared by the company's management on 30th April, 2013, and approved by the board on 30th May, 2013.

Solution

As per para 8 of AS 4 "Contingencies and Events Occurring After the Balance Sheet Date, adjustments to assets and liabilities are required for events occurring after the

---

* *These events, however, are disclosed in the financial statements instead of report of directors as per Exposure Draft on Limited Revision to AS 4. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date.

In the given case, since Raj Ltd. was sued by a competitor for infringement of a trademark during the year 2012-13 for which the provision was also made by it, the decision of the Court on 18th May, 2013, for payment of the penalty will constitute as an adjusting event because it is an event occurred before approval of the financial statements. Therefore, Raj Ltd. should adjust the provision upward by ₹ 4 lakhs to reflect the award decreed by the Court to be paid by them to its competitor.

Had the judgment of the Court been delivered on 1st June, 2013, it would be considered as post reporting period i.e. event ocurred after the approval of the financial statements. In that case, no adjustment in the financial statements of 2012-13 would have been required.

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

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

Accounting standard 5, prescribes classification and disclosure requirements for items of income/gains and expenses/losses recognised in a statement of profit and loss.

For the purpose, AS 5 puts items recognised in statements of profit and loss in six broad groups, namely :-

(i) Ordinary

(ii) Ordinary but exceptional

(iii) Extra-ordinary

(iv) Prior period items

(v) Changes in accounting policies

(vi) Changes in accounting estimates.

The presentation and disclosure requirements are such that special nature of an item is apparent to the reader of financial statement.

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

The standard is mandatory and applies to all enterprises.

Definitions

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

- ***Ordinary activities*** are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.
- ***Extraordinary items*** are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.
- ***Prior period items*** are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.
- ***Accounting policies*** are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

The important requirements regarding different items are as below:

Ordinary Activities

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

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

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

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

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions

Extraordinary Items

- The extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period.

- The nature and the amount of each extraordinary item should be separately disclosed in the statement of profit and loss in a manner that its impact on current profit or loss can be perceived. (Paragraph 8)
- Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.
- Examples of events or transactions that generally give rise to extraordinary items for most enterprises are attachment of property of the enterprise; or an earthquake.

Prior Period Items

- The nature and amount of prior period items should be separately disclosed in the statement of profit and loss in a manner that their impact on current profit or loss can be perceived. (Paragraph 15)
- The term 'prior period items', as defined in this Statement, refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.
- The prior period items are normally included in determination of net profit or loss for the current period. Alternatively, where the prior period items are not taken in computation of current profit, they can be added (or deducted as the case may be) from the current profit In either case, the disclosure should be such as to clearly show the effects of such items. (Paragraph 19)

Changes in Accounting Estimates

- The students are aware that many items of financial statements, e.g. provision for doubtful debts and depreciation, are estimates rather than precise measures.
- As per paragraph 23 of the standard, the change in accounting estimate should be included in the determination of net profit or loss in:
  - the period of change, if the change affects the period only; or
  - the period of change and the future periods, if the change affects both.
- A change in estimate for doubtful debts affects current period only, while a change in estimated working life of a depreciable asset affects current as well as future periods.

- The effect of a change in accounting estimate should be classified using the same classification in the statement of profit and loss as was used previously for the estimate. (Paragraph 25)
- If the change of accounting estimate affects an item previously classified as extraordinary item, the effect of change should also be taken as extraordinary item.
- The nature and amount of change in accounting estimate which has a material effect in the current period, or which is expected to have a material effect in subsequent periods, should be disclosed. If it is impracticable to quantify the amount, this fact should be disclosed. (Paragraph 27)

Illustration 5

An extract from the statement profit and loss of a company for 2012-13 is given below:

	₹ 000	*₹ 000*
Sales		*3,000*
Opening stock	*500*	
Production cost	*2,800*	
	3,300	
Less: Closing Stock	*(600)*	*(2,700)*
Gross Profit		*300*
Expenses		*(250)*
Profit before tax		*50*
Tax		*20*
Profit after tax		*30*

The closing stock includes stock damaged in a fire in 2011-12. On 31/03/12, the estimated net realisable value of this stock was ₹ 15,000. The revised estimate of net realisable value of the damaged stock included in closing stock of 2012-13 is ₹ 5,000.

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

Solution

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

The difference between cost of the stock and its net realisable value after fire was presumably classified as loss on fire in 2011-12. The loss on fire is an extraordinary item. Since paragraph 25 does not permit change in classification, the fall in net realisable value of damaged stock ₹ 10,000 should be classified as extra ordinary item in 2011-12 as well.

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

	₹ 000	₹ 000
Sales		3,000
Opening stock (500 – 15)	485	
Production cost	2,800	
	3,285	
Less: Closing Stock (600 – 5)	(595)	(2,690)
Gross Profit		310
Expenses		250
Profit before loss on fire		60
Less: Loss on fire		(10)
Profit before tax		50
Tax		20
Profit after tax		30

Accounting Policies

- These are specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.
- A change in accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate preparation or presentation of the financial statements of the enterprise.
- As per paragraph 32 of the standard, any material effect of change in accounting policy should be disclosed in the financial statement. The impact of, and the adjustments resulting from such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change.
- Where the effect of change in accounting policy is not ascertainable, the fact should be indicated.
- Where the change does not have any material effect in current period, but is reasonably expected to materially affect the later periods, the fact of change should be appropriately disclosed in the current period.
- As per paragraph 22 of the standard, sometimes it is difficult to distinguish between change in accounting policy and change in accounting estimate. In such cases the change is treated as change in accounting estimate, with appropriate disclosure.

Illustration 6

Cost of a machine acquired on 01/04/2010 was ₹ 1,00,000. The machine is expected to realise ₹ 5,000 at the end of its working life of 10 years. Straight-line depreciation of ₹ 9,500 per year has been charged upto 2011-12. For and from 2012-13, the company switched over to 17% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 13 years. The new rate shall apply with retrospective effect from 01/04/10.

Solution

WDV of asset at the end of *2011-12*= ₹ 1,00,000 – ₹ 9,500 x 2 = ₹ 81,000

WDV of asset at the end *2011-12* (by reducing balance method)

= ₹ 1,00,000 $(1 – 0.17)^2$ = ₹ 68,890

Depreciation to be charged in 2012-13

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

In this example, the revision of remaining useful life is change in accounting estimate, and adoption of reducing balance method of depreciation instead of the straight-line method is change in accounting policy. Since it is difficult to segregate impact of these two changes, the entire amount of difference between depreciation at old rate and depreciation charged in 2012-13 (₹ 23,821 – ₹ 9,500 = ₹ 14,321) is regarded as effect of change in accounting estimate as per paragraph 22 of the standard.

Illustration 7

The company finds that the stock sheets of 31.3.2012 did not include two pages containing details of inventory worth ₹ 20 lakhs. State, how will you deal with this matter in the accounts of A Ltd., for the year ended 31st March, 2013 with reference to AS 5.

Solution

As per para 16 of AS 5 on 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', omission of two pages containing details of inventory worth ₹ 20 lakhs in 31.3.2012 is a prior period item. As per para 19 of the standard, prior period items are normally included in the determination of net profit or loss for the current period. Accordingly, ₹ 20 lakhs must be added to opening stock of 1.4.2012. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Illustration 8

Explain whether the following will constitute a change in accounting policy or not as per AS 5.

(i) Introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement.

(ii)* *Management decided to pay pension to those employees who have retired after completing 5 years of service in the organistaion. Such employees will get pension of ₹ 20,000 per month. Earlier there was no such scheme of pension in the organization.

Solution

As per para 31 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies', the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, will not be considered as a change in accounting policy.

(i)* *Accordingly, introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement is not a change in an accounting policy.

(ii)* *Similarly, the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial will not be treated as a change in an accounting policy.

2.3 AS 11: The Effects of Changes in Foreign Exchange Rates

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

Scope

This Statement should be applied

(a) In accounting for transactions in foreign currencies.

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

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

This Statement does not

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

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

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

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

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

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

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

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

Definitions

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

- ***Average rate*** is the mean of the exchange rates in force during a period.
- ***Closing rate*** is the exchange rate at the balance sheet date.
- ***Exchange difference*** is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.
- ***Exchange rate*** *is* the ratio for exchange of two currencies.
- ***Fair value*** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- ***Foreign currency*** *is* a currency other than the reporting currency of an enterprise.
- ***Foreign operation*** is a subsidiary, associates, joint venture or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.
- ***Forward exchange contract*** means an agreement to exchange different currencies at a forward rate.
- ***Forward rate*** is the specified exchange rate for exchange of two currencies at a specified future date.
- ***Integral foreign operation*** is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.
- ***Monetary items*** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money.
- ***Net investment*** in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.
- ***Non-integral foreign operation*** is a foreign operation that is not an integral foreign operation.
- ***Non-monetary items*** are assets and liabilities other than monetary items.
- ***Reporting currency*** is the currency used in presenting the financial statements.

Initial Recognition

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

- ***Monetary items*** are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. For example, cash, receivables and payables**.**
- ***Non-monetary items*** are assets and liabilities other than monetary items. For example, fixed assets, inventories and investments in equity shares**.**

At each balance sheet date

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

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

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

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

Recognition of Exchange Differences

Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise.

However, exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised. Exchange difference is the difference resulting from reporting the same number of units of a foreign currency in the reporting currency at different exchange rates.

An exchange difference results when there is a change in the exchange rate between the transaction date and the date of settlement of any monetary items arising from a foreign currency transaction.

When the transaction is settled within the same accounting period as that in which it occurred, all the exchange difference is recognised in that period.

When the transaction is settled in a subsequent accounting period, the exchange difference recognised in each intervening period up to the period of settlement is determined by the change in exchange rates during that period.

Note:

Central Government in consultation with National Advisory Committee on Accounting Standards made an amendment to AS 11 "The Effects of Changes in Foreign Exchange Rates" in the form of Companies (Accounting Standards) Amendment Rules, 2009 and 2011.

According to the recent Notification, exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, insofar as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in the Foreign Currency Monetary Item Translation Difference (FCMITD) Account and should be written off over the useful life of the assets (amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods) but not beyond 31st March, 2020.

Ministry of Corporate Affairs vide its notification number G.S.R 913(E), dated 29th December, 2011, has amended the para 46 of AS 11 of the Companies (Accounting Standards) Amendment Rules, 2011. Through this notification, the MCA has extended the option (for the enterprises) to capitalize the exchange differences arising on reporting of long term foreign currency monetary items till 31st March, 2020 instead of 31st March, 2012. Thus the treatment availed at the option of the company shall be irrevocable and shall be exercised till 31st March, 2020.

Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously, recognised in the profit and loss account before the exercise of the option shall be reversed insofar as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to Foreign Currency Monetary Item Translation Difference (FCMITD) Account, and by debit or credit, as the case may be, to the general reserve.

If the above option is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability.

Insertion of para 46A in Accounting Standard 11 of the Companies (Accounting Standards) Rules, 2006

Ministry of Corporate Affairs vide its notification number G.S.R 914(E), dated 29th December, 2011, inserted under-mentioned para 46A in AS 11 of the Companies (Accounting Standards) Rules, 2006, now known as Companies (Accounting Standards) (Second Amendment) Rules, 2011.

"46A. (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital assets, can be added to or deducted from the cost of the assets and shall be depreciated over the balance life of the assets, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term assets or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability.

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Note: The principal regulations were published in the Gazette of India Extraordinary, Part II, Section 3, Sub Section (i) vide G.S.R 739(E), dated the 7th December, 2006 and amended vide notification number G.S.R. 212(E), dated the 27th March, 2008 and subsequently amended by No. G.S.R. 225(E) dated 31st March, 2009 and No. G.S.R. 378(E), dated 11th May, 2011.

The Ministry has received several representations from industry associations that Para 6 of AS 11 and Para 4(e) of AS 16 are posing problems in proper implementation of Para 46A of AS 11 inserted vide notification 914(E) dated 29.12.2011. In order to resolve the problems faced by industry, MCA had further clarified vide Circular No. 25/2012 dated 09.08.2012 that Para 6 of AS 11 and Para 4(e) of the AS 16 shall not apply to a company which is applying clause Para 46A of AS 11.

Illustration 9

Kalim Ltd. borrowed US$ 4,50,000 on 01/01/2012, which will be repaid as on 31/07/2012. X Ltd. prepares financial statement ending on 31/03/2012. Rate of exchange between reporting currency (INR) and foreign currency (USD) on different dates are as under:

01/01/2012	*1 US$ = ₹ 48.00*
31/03/2012	*1 US$ = ₹ 49.00*
31/07/2012	*1 US$ = ₹ 49.50*

Solution

Journal Entries in the Books of Kalim Ltd.

Date	Particulars		₹ (Dr.)	₹ (Cr.)
Jan. 01, 2012	Bank Account (4,50,000 x 48)	Dr.	216,00,000	
	To Foreign Loan Account			216,00,000
Mar. 31, 2012	Foreign Exchange Difference Account	Dr.	4,50,000	
	To Foreign Loan Account [4,50,000 x(49-48)]			4,50,000
Jul. 01, 2012	Foreign Exchange Difference Account [4,50,000x(49.5-49)]	Dr.	2,25,000	
	Foreign Loan Account	Dr.	220,50,000	
	To Bank Account			2,22,75,000

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

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

  Translation of Foreign Integral Operations

  (a) The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself.

  (b) The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation.

  (c) The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Change in the classification of a Foreign Operation

- When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve.

- When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

Illustration 10

Opportunity Ltd. purchased an equipment costing ₹ 24,00,000 lakhs on 1.4.2013 and the same was fully financed by foreign currency loan (US Dollars) payable in four annual equal installments. Exchange rates were 1 Dollar = ₹ 60.00 and ₹ 62.50 as on 1.4.2013 and 31.3.2014 respectively. First installment was paid on 31.3.2014. The entire difference in foreign exchange has been capitalized. You are required to state that how these transactions would be accounted for.

Solution

As per para 13 of AS 11 (Revised 2003) 'The Effects of Changes in Foreign Exchange Rates', exchange differences arising on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, should be recognized as income or expenses in the period in which they arise. Thus, exchange differences arising on repayment of liabilities incurred for the purpose of acquiring fixed assets will be recognized as income or expense.

Calculation of Exchange Difference:

Foreign currency loan =	*₹ 24,00,000/60 = 40,000 US Dollars*
Exchange difference =	*40,000 US Dollars × (62.50-60.00) = ₹ 1,00,000*
(including exchange loss on payment of first instalment)	

Therefore, entire loss due to exchange differences amounting ₹ 1,00,000 should be charged to profit and loss account for the year.

Note: The above answer has been given on the basis that the company has not availed the option for capilisation of exchange difference as per para 46/ 46A of AS 11.

However, as per para 46A of the standard, the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, in case Opportunity Ltd. opts for capitalizing the exchange difference, then the entire amount of exchange difference of ₹ 1,00,000 will be capitalsied to 'Equipment account'. This capitalized exchange difference will be depreciated over the useful life of the asset.

Cost of the asset on the reporting date

Initial cost of Equipment	***₹ 24,00,000***
Add: Exchange difference as on 31.3.2014	***₹ 1,00,000***
Total cost on the reporting date	***₹ 25,00,000***

Illustration 11

A business having the Head Office in Kolkata has a branch in UK. The following is the trial balance of Head Office and Branch as at 31.03.2013:

Account Name	*Amount in £*	
	Dr.	*Cr.*
Fixed Assets (Purchased on 01.04.2010)	*5,000*	
Debtors	*1,600*	
Opening Stock	*400*	
Goods received from Head Office Account	*6,100*	
(Recorded in HO books as ₹ 4,02,000)		
Sales		*20,000*
Purchases	*10,000*	
Wages	*1,000*	
Salaries	*1,200*	
Cash	*3,200*	
Remittances to Head Office (Recorded in HO books as ₹ 1,91,000)	*2,900*	
Head Office Account (Recorded in HO books as ₹ 4,90,000)		*7,400*
Creditors		*4,000*

- *Closing stock at branch is £ 700 on 31.03.2013.*
- *Depreciation @ 10% p.a. is to be charged on fixed assets.*
- *Prepare the trial balance after been converted in Indian Rupees.*
- *Exchange rates of Pounds on different dates are as follow:*
  01.04.2010– ₹ 61; 01.04.2012– ₹ 63 & 31.03.2013 – ₹ 67

Solution

Trial Balance of the Foreign Branch converted into Indian Rupees as on March 31, 2013

Particulars	£ (Dr.)	£ (Cr.)	Conversion Basis	₹ (Dr.)	₹ (Cr.)
Fixed Assets	5,000		Transaction Date Rate	3,05,000	
Debtors	1,600		Closing Rate	1,07,200	
Opening Stock	400		Opening Rate	25,200	
Goods Received from HO	6,100		Actuals	4,02,000	
Sales		20,000	Average Rate		13,00,000
Purchases	10,000		Average Rate	6,50,000	
Wages	1,000		Average Rate	65,000	
Salaries	1,200		Average Rate	78,000	
Cash	3,200		Closing Rate	2,14,400	
Remittance to HO	2,900		Actuals	1,91,000	
HO Account		7,400	Actuals		4,90,000
Creditors		4,000	Closing Rate		2,68,000
Exchange Rate Difference			Balancing Figure	20,200	
	31,400	31,400		20,58,000	20,58,000
Closing Stock	700		Closing Rate	46,900	
Depreciation	500		Fixed Asset Rate	30,500	

- Forward exchange contract means an agreement to exchange different currencies at a forward rate[1].

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

- An enterprise may enter into a forward exchange contract or another financial instrument that is in substance a forward exchange contract, which is not intended for trading or speculation purposes, to establish the amount of the reporting currency required or available at the settlement date of a transaction.
- The premium or discount arising at the inception of such a forward exchange contract should be amortised as expense or income over the life of the contract.

[1] After issuance of AS 30, limited revision was made to AS 11 to withdraw the requirements concerning forward exchange contracts from AS 11. However, ASB issued a clarification regarding applicability of AS 30 in February, 2011 which states that limited revisions due to AS 30 will not be given effect to in respect of any existing notified accounting standards. Accordingly, forward exchange contracts will be dealt with as per the provisions of AS 11 only.

- Exchange differences on such a contract should be recognised in the statement of profit and loss in the reporting period in which the exchange rates change.
- Any profit or loss arising on cancellation or renewal of such a forward exchange contract should be recognised as income or as expense for the period.
- In recording a forward exchange contract intended for trading or speculation purposes, the premium or discount on the contract is ignored and at each balance sheet date, the value of the contract is marked to its current market value and the gain or loss on the contract is recognised.

Illustration 12

Rau Ltd. purchased a plant for US$ 1,00,000 on 01st February 2012, payable after three months. Company entered into a forward contract for three months @ ₹ 49.15 per dollar. Exchange rate per dollar on 01st Feb. was ₹ 48.85. How will you recognize the profit or loss on forward contract in the books of Rau Ltd.

Solution

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

Contract period 3 months

Two falling the year 2012-13; therefore loss to be recognized (30,000/3) x 2 =
₹ 20,000.Rest ₹ 10,000 will be recognized in the following year.

Illustration 13

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

Solution

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

Sale Rate	₹ 47.18
Less: Contract Rate	(₹ 47.10)
Premium on Contract	₹ 0.08

Contract Amount	US$ 1,00,000
Total Profit (1,00,000 x 0.08)	₹ 8,000

Disclosure

An enterprise should disclose:

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

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

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

Presentation of Foreign Currency Monetary Item Translation Difference Account (FCMITDA)

In the Revised Schedule VI (now Schedule III to the Companies Act, 2013) format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)". Therefore, the Council of the Institute at its 324th meeting held on March 24-26, 2013 at New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet.

The Council considered the definition of an asset given in the Framework on Preparation and Presentation of Financial Statements issued by ICAI which states as follows:

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset.

Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

Paragraphs 46 for entities other than Companies

46 (1) In respect of accounting periods commencing on or after 7th December, 2006 (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation

Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Illustration 14

Option Ltd. is engaged in the manufacturing of steel. For its steel plant, it required machineries of latest technology. It usually resorts to Long Term Foreign Currency Borrowings for its fund requirements. On 1st April, 2011, it borrowed US $1 million from International Funding Agency, USA when exchange rate was 1 $ = ₹ 52. The funds were used for acquiring machineries on the same date to be used in three different steel plants. The useful life of the machineries is 10 years and their residual value is ₹ 20,00,000.

Earlier also the company used to purchase machineries out of foreign borrowings. The exchange differences arising on such borrowings were charged to profit and loss account and were not capitalised even though the company had an option to capitalise it as per notified AS 11 (notification issued by the MCA in 2009).

Now for this new purchase of machinery, Option Ltd, is interested to avail the option of capitalising the same to the cost of asset. Exchange rate on 31st March, 2012 is 1 US $ = ₹ 51. Assume that on 31st March, 2012, Option Ltd. is not having any old Long term foreign currency borrowings except for the amount borrowed for machinery purchased on 1st April, 2011.

Can Option Ltd. capitalise the exchange difference to the cost of asset on 31st March, 2012? If yes, then calculate the depreciation amount on machineries as on 31st March, 2012.

Solution

Ministry of Corporate Affairs, Government of India, inserted paragraph 46A in notified AS 11 by Notification dated 29th December, 2011, which is relevant for companies. It states that in respect of accounting periods commencing on or after 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 or not (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset.

Accordingly, though Option Ltd. had not earlier exercised the option as given by the notification on AS 11, issued in 2009, yet it can avail the option to capitalise the exchange difference to the cost of machinery by virtue of para 46A inserted in the notified AS 11 in December, 2011.

Exchange difference to be capitalised

Cost of the asset in $		$ 10 lakhs
Exhange rate on 1st April, 2011		₹ 52 = 1$
Cost of the asset in ₹	($ 10 lakhs x ₹ 52)	520 lakhs
Less: Exchange differences as on 31st March, 2012 (52-51) x $ 1 million	(Gain)	(10 lakhs)
		510 lakhs
Less: Depreciation for 2011-12	(510 lakhs - 20 lakhs)/10 years	(49 lakhs)
		461 lakhs

Change in classification of a significant foreign operation

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

a. The nature of the change in classification;

b. The reason for the change;

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

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

2.4 AS 12 : Accounting for Government Grants

The Standard came into effect in respect of accounting periods commencing on or after 1.4.1992 and is mandatory for all entities.

Introduction

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

(b) This Standard does not deal with

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

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

iii. Government participation in the ownership of the enterprise.

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

Accounting Treatment

Capital Approach versus Income Approach

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

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

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

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

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

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

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

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

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

In most cases, the periods over which an enterprise recognizes the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

Recognition of Government Grants

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

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

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

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

Non-monetary Government Grants

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

Presentation of Grants Related to Specific Fixed Assets

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

Method I :

- The grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value.
- The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge.
- Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

Illustration 15

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

Solution

Journal in the books of Z Ltd.

Year	Particulars		₹ (Dr.)	₹ (Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being Fixed Assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Fixed Assets Account			10,00,000
	(Being grant received from the government)			
	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P/L Account)			
2nd	Depreciation Account	Dr.	7,00,000	
	To Fixed Assets Account			7,00,000
	(Being Depreciation charged on SLM)			
	Profit & Loss Account	Dr.	7,00,000	
	To Depreciation Account			7,00,000
	(Being Depreciation transferred to P/L Account)			

Method II:

- Grants related to depreciable assets are treated as deferred income which is recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset.
- Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets.
- If a grant related to a non-depreciable asset requires the fulfilment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income.

Illustration 16

Z Ltd. purchased a fixed asset for ₹ 50 lakhs, which has the estimated useful life of 5 years with the salvage value of ₹ 5,00,000. On purchase of the assets government granted it a grant for

₹ 10 lakhs. Pass the necessary journal entries in the books of the company for first two years if the grant is treated as deferred income.

Solution

Journal in the books of Z Ltd.

Year	Particulars		₹ (Dr.)	₹ (Cr.)
1st	Fixed Assets Account	Dr.	50,00,000	
	To Bank Account			50,00,000
	(Being fixed assets purchased)			
	Bank Account	Dr.	10,00,000	
	To Deferred Government Grant Account			10,00,000
	(Being grant received from the government)			
	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grants Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L Account)			
2nd	Depreciation Account	Dr.	9,00,000	
	To Fixed Assets Account			9,00,000
	(Being depreciation charged on SLM)			
	Profit & Loss Account	Dr.	9,00,000	
	To Depreciation Account			9,00,000
	(Being depreciation transferred to P/L Account)			
	Deferred Government Grant Account	Dr.	2,00,000	
	To Profit & Loss Account			2,00,000
	(Being proportionate government grant taken to P/L Account)			

Presentation of Grants Related to Revenue

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

Presentation of Grants of the nature of Promoters' contribution

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

Refund of Government Grants

- Government grants sometimes become refundable because certain conditions are not fulfilled and are treated as an extraordinary item (AS 5).
- The amount refundable in respect of a government grant related to revenue is applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement.
- The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the deferred income balance, as appropriate, by the amount refundable.
- Where a grant which is in the nature of promoters' contribution becomes refundable, in part or in full, to the government on non-fulfillment of some specified conditions, the relevant amount recoverable by the government is reduced from the capital reserve.

Illustration 17

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

Solution

Fixed Assets Account	Dr.	₹7,00,000	
To Bank Account			₹7,00,000

(Being government grant on asset refunded)

Disclosure

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

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

Illustration 18

A fixed asset is purchased for ₹ 20 lakhs. Government grant received towards it is ₹ 8 lakhs. Residual Value is ₹ 4 lakhs and useful life is 4 years. Assume depreciation on the basis of Straight Line method. Asset is shown in the balance sheet net of grant. After 1 year, grant becomes refundable to the extent of ₹ 5 lakhs due to non compliance with certain conditions. Pass journal entries for first two years.

Solution

Journal Entries

Year	*Particulars*		*₹ in lakhs (Dr.)*	*₹ in lakhs (Cr.)*
1	Fixed Asset Account	Dr.	20	
	To Bank Account			20
	(Being fixed asset purchased)			
	Bank Account	Dr.	8	
	To Fixed Asset Account			8
	(Being grant received from the government reduced the cost of fixed asset)			
	Depreciation Account (W.N.1)	Dr.	2	
	To Fixed Asset Account			2
	(Being depreciation charged on Straight Line method (SLM))			
	Profit & Loss Account	Dr.	2	
	To Depreciation Account			2
	(Being depreciation transferred to Profit and Loss Account at the end of year 1)			
2	Fixed Asset Account	Dr.	5	
	To Bank Account			5
	(Being government grant on asset partly refunded which increased the cost of fixed asset)			
	Depreciation Account (W.N.2)	Dr.	3.67	
	To Fixed Asset Account			3.67
	(Being depreciation charged on SLM on revised value of fixed asset prospectively)			

	Profit & Loss Account Dr.		3.67	
	To Depreciation Account			3.67
	(Being depreciation transferred to Profit and Loss Account at the end of year 2)			

Working Notes:

1. Depreciation for Year 1

	₹ *in lakhs*
Cost of the Asset	20
Less: Government grant received	(8)
	12
Depreciation $\left[\frac{12-4}{4}\right]$	2

2. Depreciation for Year 2

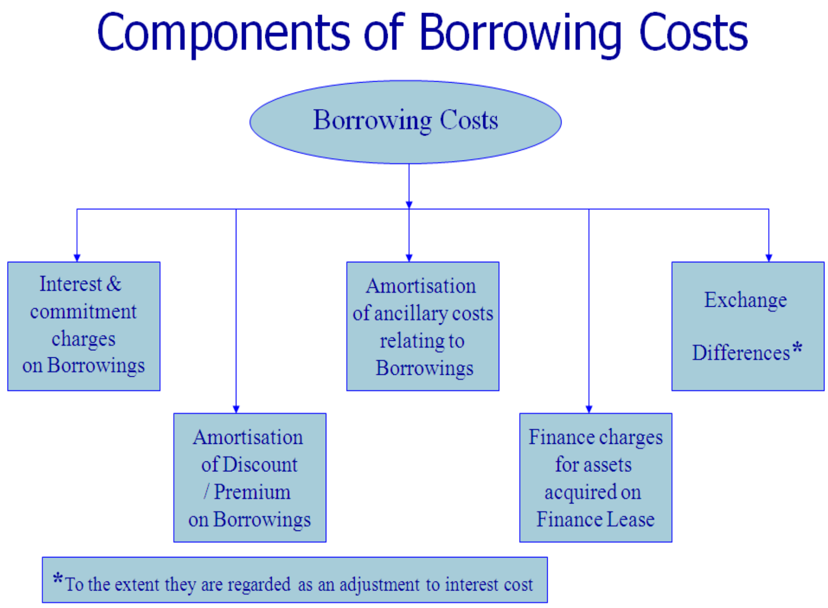
	₹ *in lakhs*
Cost of the Asset	20
Less: Government grant received	(8)
	12
Less: Depreciation for the first year $\left[\frac{12-4}{4}\right]$	2
	10
Add: Government grant refundable	5
	15
Depreciation for the second year $\left[\frac{15-4}{3}\right]$	3.67

2.5 AS 16 : Borrowing Costs

This Standard came into effect in respect of accounting periods commencing on or after 1-4-2000 and is mandatory in nature.

It does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

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



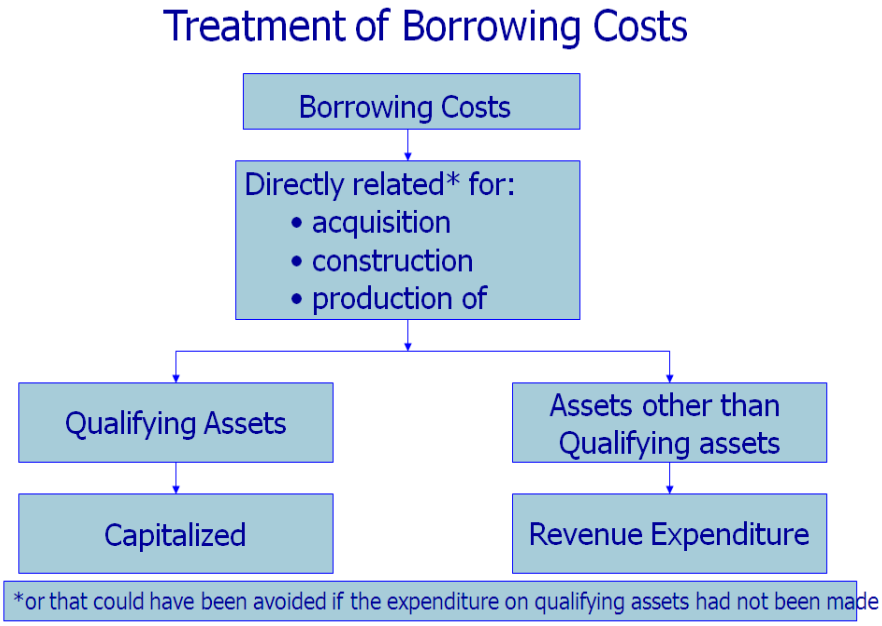
A ***qualifying asset*** is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Accounting standard further clarifies the meaning of the expression 'substantial period of time'. According to it, substantial period of time primarily depends on the facts and circumstances of each case. It further states that, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of the facts and circumstances of the case. In estimating the period, time which an asset takes technologically and commercially target if ready for its intended use or sale should be considered.

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

Borrowing Costs Eligible for Capitalisation



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

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

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

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

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

Commencement of Capitalisation

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

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

b. Borrowing costs are being incurred.

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

Suspension of Capitalisation

Borrowing costs may be incurred during an extended period in which the activities necessary to prepare an asset for its intended use or sale are interrupted. Such costs are costs of holding partially completed assets and do not qualify for capitalisation. However, capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Capitalisation of borrowing costs is also not suspended when a temporary delay is a necessary part of the process of getting an asset ready for its intended use or sale. For example: capitalisation continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

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

When the construction of a qualifying asset is completed in parts and a completed part is capable of being used while construction continues for the other parts, capitalisation of borrowing costs in relation to a part should cease when substantially all the activities necessary to prepare that part for its intended use or sale are complete. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts.

Disclosure

The financial statements should disclose:

a. The accounting policy adopted for borrowing costs; and

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

Illustration 19

An industry borrowed ₹ 40,00,000 for purchase of machinery on 1.6.2011. Interest on loan is 9% per annum. The machinery was put to use from 1.1.2012. Pass journal entries for the year ended 31.3.2012 to record the borrowing cost of loan, as per AS 16.

Solution

		₹
Interest upto 31.3.2012 (40,00,000 × 9% × $\frac{10}{12}$ months)	=	3,00,000
Less: Interest relating to pre-operative period 3,00,000 × $\frac{7}{10}$	=	(2,10,000)
Amount to be charged to P&L A/c	=	90,000
Pre-operative interest to be capitalized	=	2,10,000

Journal Entries

		₹	₹
Machinery A/c	Dr.	2,10,000	
To Loan A/c			2,10,000
(Being interest on loan for pre-operative period capitalized)			
Interest on loan A/c	Dr.	90,000	
To Loan A/c			90,000
(Being the interest on loan for the post-operative period)			
Profit and Loss A/c	Dr.	90,000	
To Interest on loan A/c			90,000
(Being interest on loan transferred to P&L A/c)			

Illustration 20

X Ltd. began construction of a new building on 1st January, 2012. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2012 at an interest rate of 10%. The company's other outstanding two non-specific loans were:

Amount	*Rate of Interest*
₹ 5,00,000	*11%*
₹ 9,00,000	*13%*

The expenditures that were made on the building project were as follows:

		₹
January	*2012*	*2,00,000*
April	*2012*	*2,50,000*
July	*2012*	*4,50,000*
December	*2012*	*1,20,000*

Building was completed by 31st December, 2012. Following the principles prescribed in AS 16 'Borrowing Cost,' calculate the amount of interest to be capitalized and pass one Journal Entry for capitalizing the cost and borrowing cost in respect of the building.

Answer

(i) Computation of average accumulated expenses

		₹
₹ 2,00,000 x 12 / 12	=	2,00,000
₹ 2,50,000 x 9 / 12	=	1,87,500
₹ 4,50,000 x 6 / 12	=	2,25,000
₹ 1,20,000 x 1 / 12	=	10,000
		6,22,500

(ii) Calculation of average interest rate other than for specific borrowings

Amount of loan (₹)	Rate of interest		Amount of interest (₹)
5,00,000	11%	=	55,000
9,00,000	13%	=	1,17,000
14,00,000			1,72,000
Weighted average rate of interest $\left(\frac{1,72,000}{14,00,000}\times 100\right)$		=	12.285% (approx)

(iii) Interest on average accumulated expenses

		₹
Specific borrowings (₹ 1,00,000 x 10%)	=	10,000
Non-specific borrowings (₹ 5,22,500* x 12.285%)	=	64,189
Amount of interest to be capitalized	=	74,189

(iv) Total expenses to be capitalized for building

	₹
Cost of building ₹ (2,00,000 + 2,50,000 + 4,50,000 + 1,20,000)	10,20,000
Add: Amount of interest to be capitalised	74,189
	10,94,189

(v) Journal Entry

Date	Particulars		Dr. (₹)	Cr. (₹)
31.12.2012	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)			

Illustration 21

Take Ltd. has borrowed ₹ 30 lakhs from State Bank of India during the financial year 2013-14. The borrowings are used to invest in shares of Give Ltd., a subsidiary company of Take Ltd., which is implementing a new project, estimated to cost ₹ 50 lakhs. As on 31st March, 2014, since the said project was not complete, the directors of Take Ltd. resolved to capitalize the interest accruing on borrowings amounting to ₹ 4 lakhs and add it to the cost of investments. Comment.

Solution

Cost of investment includes acquisition charges such as brokerage, fees and duties. In the present case, Take Ltd. has used borrowed funds for purchasing shares of its subsidiary company Give Ltd. ₹ 4 lakhs interest payable by Take Ltd. to State Bank of India cannot be called as acquisition charges, therefore, cannot be constituted as cost of investment.

Further, as per para 3 of AS 16 "Borrowing Costs", a qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale. Since, shares are ready for its intended use at the time of sale, it cannot be considered as qualifying asset that can enable a company to add the borrowing cost to investments. Therefore, the directors of Take Ltd. cannot capitalise the borrowing cost

* (₹ 6,22,500 – ₹ 1,00,000)

as part of cost of investment. Rather, it has to be charged to the Statement of Profit and Loss for the year ended 31st March, 2014.

2.6 AS 19 : Leases

Introduction

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

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

Applicability of Accounting Standard

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

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

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

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

(c) lease agreements to use lands

(d) agreements that are contracts for services, that do not transfer right to use assets from one contracting party to the other.

Types of leases

For accounting purposes, leases are classified as:

(i) *Finance leases; and*

(ii) *Operating leases*.

A *Finance Lease* is a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not be eventually transferred. A lease is classified as an *Operating L*ease if it does not transfer substantially all the risk and rewards incident to ownership.

Situations, which would normally lead to a lease being classified as a finance lease are:

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

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

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

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

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

Indicators of Finance Lease

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

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

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

Lease Payments

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

Accounting for Finance Leases (Books of lessee)

Following is the accounting treatment of Finance Leases in the books of Lessee:

(i) On the date of inception of Lease, Lessee should show it as an asset and corresponding liability at lower of:
   - Fair value of leased asset
   - Present value of minimum lease payments (present value to be calculated with discount rate equal to interest rate implicit in the lease)

(ii) Lease payments to be apportioned between the finance charge and the reduction of the outstanding liability.

(iii) Finance charges to be allocated to periods during the lease term so as to produce a constant rate of interest on the remaining balance of liability for each period.

(iv) Charge depreciation on leased asset on the same lines as any other asset. If there is not certainity that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term.

Computation of interest rate implicit on lease

Discounting rate = R% p.a;

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

Lease period = n years;

Guaranteed residual value = GR;

Unguaranteed residual value = UGR

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

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

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

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

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

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

Example 1

Annual lease rents = *₹ 50,000 at the end of each year.*

Lease period = *5 years;*

Guaranteed residual value = *₹ 25,000*

Unguaranteed residual value = *₹ 15,000*

Fair Value at the inception (beginning) of lease = *₹ 2,00,000*

Interest rate implicit on lease is computed below:

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

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

Year	Lease Payments ₹	DF (10%)	PV ₹
1	50,000	0.909	45,450
2	50,000	0.826	41,300
3	50,000	0.751	37,550
4	50,000	0.683	34,150
5	50,000	0.621	31,050
5	25,000	0.621	15,525
5	15,000	0.621	9,315
			2,14,340

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

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

Interest rate implicit on lease is computed below by interpolation:

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

Recognition of asset and liability

At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability at lower of

(i) present value of minimum lease payments and

(ii) fair value of leased asset.

The discounting rate should be interest rate implicit on lease. Where interest rate implicit on lease is not determinable, the lessee's incremental borrowing rate should be used as discounting rate. (As distinguished from rate of interest on lessee's existing loans, the incremental borrowing rate is the rate of interest at which the lessee can borrow fresh funds under terms, similar to lease arrangement.)

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

Example 2

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

Year	*MLP* ₹	*DF (12.6%)*	*PV* ₹
1	*50,000*	*0.890*	*44,500*
2	*50,000*	*0.790*	*39,500*
3	*50,000*	*0.700*	*35,000*
4	*50,000*	*0.622*	*31,100*
5	*50,000*	*0.552*	*27,600*
5	*25,000*	*0.552*	*13,800*
5	*15,000*	*0.552*	*8,280*
			1,99,780

Present value of minimum lease payment = ₹ 1,99,780

Fair value of leased asset = ₹ 2,00,000

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

	₹	₹
Asset A/c Dr.	*1,99,780*	
To Lessor		*1,99,780*
(Being recognition of finance lease as asset and liability)		

Recognition of Finance Charge (Paragraph 16)

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

Example 3

Using data for example 1 and assuming zero residual value, allocation of finance charge over lease period is shown below:

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

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

	₹	₹
Finance Charge A/c Dr.	*24,129*	
To Lessor		*24,129*
(Being finance charge due for the year)		

* The difference between this figure and finance charge [66,763×12.6%=8412] is due to approximation in computation.

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

Example 4

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

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

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

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

Present value of minimum lease payment = ₹ 2,05,025

Fair value of leased asset = ₹ 2,00,000

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

	₹	₹
Asset A/c Dr.	*2,00,000*	
To Lessor		*2,00,000*
(Being recognition of finance lease as asset and liability)		

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

PV of minimum lease payments at guessed rate 12%

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

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

Allocation of finance charge over lease period is shown below:

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

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

		₹	₹
Finance Charge A/c	Dr.	21,900	
To Lessor			21,900
(Being finance charge due for the year)			

* The difference between this figure & finance charge [67,753×10.95% = 7418] is due to approximation in computation

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

Depreciation

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

Contingent Rents and other costs

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

Disclosures made by the Lessee (Paragraph 22)

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

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

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

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

    (i) not later than one year;

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

    (iii) later than five years;

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

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

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

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

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

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

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

Accounting for finance leases (Books of lessor)

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

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

Gross investment in Lease (GIL)

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

Minimum Lease Payments

Minimum Lease Payments (MLP) are the payments that the Lessee is to make to the Lessor, together with:

(i) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(ii) in the case of the lessor, any residual value guaranteed to the Lessor:

- by or on behalf of the lessee;or
- by an independent third party financially capable of meeting the gurantee

Unguaranteed Residual Value

Unguaranteed Residual Value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

Gross Investment

Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

Net investment in Lease (NIL)

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

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

The discounting rate for the above purpose is the rate of interest implicit in the lease.

From the definition of interest rate implicit on lease:

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

The above definitions imply that:

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

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

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

Total earning of lessor = GIL – Cost

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

= Unearned Finance Income + (Fair Value – Cost)

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

Recognition of Finance Income

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

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

Contingent Rents and Initial Direct Costs

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

Review of unguaranteed residual value by lessor

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

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

Disclosures

The lessor should make the following disclosures for finance leases:

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

(i) not later than one year;

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

(iii) later than five years;

(b) unearned finance income;

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

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

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

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

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

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

Accounting for Operating Leases

Operating leases are non-payout leases, i.e. an individual contract of operating lease does not usually recover the entire cost of leased asset for the lessor. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss of a lessee on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

Accounting treatment in the Books of lessee

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

Suppose outputs from a machine taken on a 3 year operating lease are estimated as 10,000 units in year 1,20,000 units in year 2 and 50,000 units in year 3. The agreed annual lease payments are ₹ 25,000, ₹ 45,000 and ₹ 50,000 respectively. The total lease payment ₹ 1,20,000 in this example should be recognised in proportion of output as ₹ 15,000 in year 1,

₹ 30,000 in year 2 and ₹ 75,000 in year 3. The difference between lease rent due and lease rent recognised can be debited / credited to Lease Rent Adjustment A/c.

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

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

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

Disclosures by lessees

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

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

  (i) not later than one year;

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

  (iii) later than five years;

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

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

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

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

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

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

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

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

Accounting treatment in the books of lessor

(i) Paragraph 39 requires a lessor to treat assets given under operating leases as fixed assets in its balance sheets and

(ii) Paragraph 41 requires depreciation to be recognized in the books of lessor. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6. (Paragraph 43)

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

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

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

$$\textit{Total lease rent} = 120\% \text{ of ₹ } 5 \text{ lakhs} \times \frac{\text{Output during lease period}}{\text{Total output}}$$

$$= \text{₹ } 6 \text{ lakhs} \times \frac{60{,}000 \text{ units}}{1{,}25{,}000 \text{ units}} = \text{₹ } 2.88 \text{ lakhs}$$

Annual lease rent = ₹ 2,88,000 / 3 = ₹ 96,000

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

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

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

	₹	₹
Machine given on Operating Lease Dr.	*5,00,000*	
To Purchase		*5,00,000*
(Being machine given on operating lease brought into books)		
Lessee Dr.	*96,000*	
To Lease Rent		*96,000*
(Being lease rent for the year due)		
Bank Dr.	*96,000*	
To Lessee		*96,000*
(Being receipt of lease rent for the year)		
Lease Rent Dr.	*96,000*	
To P & L A/c		*48,000*
To Lease Rent Adjustment		*48,000*
(Being recognition of lease rent as income for the year)		
Depreciation Dr.	*40,000*	
To Machine given on Operating Lease		*40,000*
(Being depreciation for the year)		
P & L A/c Dr.	*40,000*	
To Depreciation		*40,000*
(Being depreciation for the year transferred to P & L A/c)		

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

Illustration 22

S. Square Private Limited has taken machinery on lease from S.K. Ltd. The information is as under:

Lease term = 4 years

Fair value at inception of lease = ₹ 20,00,000

Lease rent = ₹ 6,25,000 p.a. at the end of year

Guaranteed residual value = ₹ 1,25,000

Expected residual value = ₹ 3,75,000

Implicit interest rate = 15%

Discounted rates for 1st year, 2nd year, 3rd year and 4th year are 0.8696, 0.7561, 0.6575 and 0.5718 respectively.

Calculate the value of the lease liability as per AS-19.

Solution

According to para 11 of AS 19 "Leases", the lessee should recognise the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of the finance lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease. Present value of minimum lease payments will be calculated as follows:

Year	*Minimum Lease Payment* ₹	*Internal rate of return (Discount rate @5%)*	*Present value* ₹
1	6,25,000	0.8696	5,43,500
2	6,25,000	0.7561	4,72,563
3	6,25,000	0.6575	4,10,937
4	7,50,000*	0.5718	4,28,850
Total	26,25,000		18,55,850

Present value of minimum lease payments ₹18,55,850 is less than fair value at the inception of lease i.e. ₹ 20,00,000, therefore, the lease liability should be recognized at ₹18,55,850 as per AS 19.

Illustration 23

Prakash Limited leased a machine to Badal Limited on the following terms:

		(₹ In lakhs)
(i)	*Fair value of the machine*	*48.00*
(ii)	*Lease term*	*5 years*
(iii)	*Lease rental per annum*	*8.00*
(iv)	*Guaranteed residual value*	*1.60*
(v)	*Expected residual value*	*3.00*
(vi)	*Internal rate of return*	*15%*

* *Minimum Lease Payment of 4th year includes guaranteed residual value amounting ₹1,25,000.*

Discounted rates for 1st year to 5th year are 0.8696, 0.7561, 0.6575, 0.5718, and 0.4972 respectively.

Ascertain Unearned Finance Income.

Solution

As per AS 19 on Leases, ***unearned finance income*** is the difference between (a) the ***gross investment*** in the lease and (b) the present value of minimum lease payments under a finance lease from the standpoint of the lessor; and any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

Where:

(a) ***Gross investment*** in the lease is the aggregate of (i) minimum lease payments from the stand point of the lessor and (ii) any unguaranteed residual value accruing to the lessor.

Gross investment = Minimum lease payments + Unguaranteed residual value

= [Total lease rent + Guaranteed residual value (GRV)] + Unguaranteed residual value (URV)

= [(₹ 8,00,000 × 5 years) + ₹ 1,60,000] + ₹ 1,40,000 = ₹ 43,00,000 (a)

(b) Table showing present value of (i) Minimum lease payments (MLP) and (ii) Unguaranteed residual value (URV).

Year	*MLP inclusive of URV* ₹	*Internal rate of return (Discount factor @ 15%)*	*Present Value* ₹
1	8,00,000	0.8696	6,95,680
2	8,00,000	0.7561	6,04,880
3	8,00,000	0.6575	5,26,000
4	8,00,000	0.5718	4,57,440
5	8,00,000	0.4972	3,97,760
	1,60,000 (GRV)	0.4972	79,552
	41,60,000		27,61,312 (i)
	1,40,000 (URV)	0.4972	69,608 (ii)
	43,00,000	(i)+ (ii)	28,30,920(b)

Unearned Finance Income (a) - (b) = ₹ 43,00,000 – ₹ 28,30,920= ₹ 14,69,080.

Disclosures by lessors

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

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

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

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

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

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

(i) not later than one year;

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

(iii) later than five years;

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

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

Note: The Level II and Level III non-corporate entities need not make disclosures required by paragraphs 46(b) and (d).

Sale and Leaseback

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

- ***Where sale and leaseback results in finance lease***

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

- ***Where sale and leaseback results in operating lease***

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

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

Case 1: Sale price = Fair Value

Profit or loss should be recognised immediately.

Case 2: Sale Price < Fair Value

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

Case 3: Sale Price > Fair Value

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

Illustration 24

A Ltd. sold machinery having WDV of ₹ 40 lakhs to B Ltd. for ₹ 50 lakhs and the same machinery was leased back by B Ltd. to A Ltd. The lease back is operating lease. Comment if –

(a) Sale price of ₹ 50 lakhs is equal to fair value.

(b) Fair value is ₹ 60 lakhs.

(c) Fair value is ₹ 45 lakhs and sale price is ₹ 38 lakhs.

(d) Fair value is ₹ 40 lakhs and sale price is ₹50 lakhs.

(e) Fair value is ₹ 46 lakhs and sale price is ₹ 50 lakhs

(f) Fair value is ₹ 35 lakhs and sale price is ₹39 lakhs.

Solution

Following will be the treatment in the given cases:

(a) When sales price of ₹ 50 lakhs is equal to fair value, A Ltd. should immediately recognize the profit of ₹10 lakhs (i.e. 50 – 40) in its books.

(b) When fair value is ₹ 60 lakhs then also profit of ₹10 lakhs should be immediately recognized by A Ltd.

(c) When fair value of leased machinery is ₹ 45 lakhs & sales price is ₹ 38 lakhs, then loss of ₹ 2 lakhs (40 – 38) to be immediately recognized by A Ltd. in its books provided loss is not compensated by future lease payment.

(d) When fair value is ₹ 40 lakhs & sales price is ₹ 50 lakhs then, profit of ₹ 10 lakhs is to be deferred and amortized over the lease period.

(e) When fair value is ₹ 46 lakhs & sales price is ₹ 50 lakhs, profit of ₹ 6 lakhs (46 - 40) to be immediately recognized in its books and balance profit of ₹4 lakhs (50-46) is to be amortised/deferred over lease period.

(f) When fair value is ₹ 35 lakhs & sales price is ₹ 39 lakhs, then the loss of ₹ 5 lakhs (40-35) to be immediately recognized by A Ltd. in its books and profit of ₹ 4 lakhs (39-35) should be amortised/deferred over lease period

2.7 AS 20 : Earnings Per Share

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

Applicability

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

- An *equity share* is a share other than a preference share.
- A *preference share* is a share carrying preferential rights to dividends and repayment of capital.

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

Examples of potential equity shares are:

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

b. Share warrants;

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

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

Objective

The objective of this standard is to prescribe principles for the determination and presentation of earnings per share, so as to improve performance comparisons between different entities in the same reporting periods for the same entity. The focus of this standard is on the denominator of the earnings per share calculation.

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

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

Basic Earnings Per Share

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

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

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

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

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

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

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

---

* *An Exposure Draft on Limited Revision on AS 20 has been issued by ICAI to address the conceptual issues in arriving at earnings for computation of EPS. According to this Exposure Draft, for purpose of calculating basic earnings per share, net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting (i) preference dividends and any attributable tax thereto for the period and (ii) adjusting the amount in respect of an item of income or expense which is debited or credited to share premium account/ reserves, that is otherwise required to be recognized in the statement of profit and loss in accordance with accounting standards. It is pertinent to note that this Limited Revision is yet to be notified by the Govt.*

Illustration 25

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

Calculate Weighted Number of Shares.

Solution

Computation of Weighted Average:

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

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

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

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

List of shares issued	Weight to be considered from
Equity shares issued in exchange for cash	Date of cash receivable
Equity shares issued as a result of the conversion of a debt instrument	Date of conversion
Equity shares issued in lieu of interest or principal on other financial instruments	Date when interest ceases to accrue
Equity shares issued in exchange for the settlement of a liability of the enterprise	Date on which the settlement becomes effective
Equity shares issued as consideration for the acquisition of an asset other than cash	Date on which the acquisition is recognised
Equity shares issued for the rendering of services to the enterprise	When the services are rendered

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

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

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

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

a. A bonus issue;

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

c. A share split; and

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

Illustration 26

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

Calculate Weighted Number of Shares.

Solution

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

Computation of weighted average would be as follows:

(1,800 x 12/12) + (300 x 2/12) = 1,850 shares

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

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

Illustration 27

Net profit for the year 2011	*₹ 18,00,000*
Net profit for the year 2012	*₹ 60,00,000*
No. of equity shares outstanding until 30th September 2012	*20,00,000*

Bonus issue 1st October 2012 was 2 equity shares for each equity share outstanding at 30th September, 2012

Calculate Basic Earnings Per Share.

Solution

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

Earnings per share for the year 2012 $= \dfrac{60,00,000}{(20,00,000+40,00,000)}$ = ₹ 1.00

Adjusted earnings per share for the year 2011 = $\dfrac{18,00,000}{(20,00,000+40,00,000)}$ = ₹ 0.30

Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2011, the earliest period reported.

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

Fair value per share immediately prior to the exercise of rights

Theoretical ex-rights fair value per share

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

Illustration 28

Net profit for the year 2011	*₹ 11,00,000*
Net profit for the year 2012	*₹ 15,00,000*
No. of shares outstanding prior to rights issue	*5,00,000 shares*
Rights issue price	*₹ 15.00*
Last date to exercise rights	*1st March 2012*

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

Fair value of one equity share immediately prior to exercise of rights on 1st March 2012 was ₹ 21.00. Compute Basic Earnings Per Share.

Solution

Fair value of shares immediately prior to exercise of rights + Total amount received from exercise. Number of shares outstanding prior to exercise + number of shares issued in the exercise

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

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor:

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

$$\frac{₹(21.00)}{₹(20.00)} = 1.05$$

Computation of earnings per share:

EPS for the year 2011 as originally reported: ₹ 11,00,000/5,00,000 shares = ₹ 2.20

EPS for the year 2011 restated for rights issue: ₹ 11,00,000/ (5,00,000 shares x 1.05) = ₹ 2.10

EPS for the year 2012 including effects of rights issue:

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

EPS = 15,00,000/5,87,500 = ₹ 2.55

Diluted Earnings Per Share

In calculating diluted earnings per share, an entity shall adjust profit or loss attributable to ordinary equity shareholders of the parent entity, and the weighted average number of shares outstanding, for the effects of all dilutive potential ordinary shares

Dilution is a reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions

Effect is given to all dilutive potential equity shares that were outstanding during the period, that is:

a. The net profit for the period attributable to equity shares is:
   i. Increased by the amount of dividends recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period;
   ii. Increased by the amount of interest recognised in the period in respect of the dilutive potential equity shares as adjusted for any attributable change in tax expense for the period; and
   iii. Adjusted for the after-tax amount of any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.
b. The weighted average number of equity shares outstanding during the period is increased by the weighted average number of additional equity shares which would have been outstanding assuming the conversion of all dilutive potential equity shares.

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

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

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

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

Illustration 29

Net profit for the current year	*₹ 1,00,00,000*
No. of equity shares outstanding	*50,00,000*
Basic earnings per share	*₹ 2.00*
No. of 12% convertible debentures of ₹ 100 each	*1,00,000*
Each debenture is convertible into 10 equity shares	
Interest expense for the current year	*₹ 12,00,000*
Tax relating to interest expense (30%)	*₹ 3,60,000*

Compute Diluted Earnings Per Share.

Solution

Adjusted net profit for the current year (1,00,00,000 + 12,00,000 – 3,60,000) = ₹ 1,08,40,000

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

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

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

Restatement

If the number of equity or potential equity shares outstanding increases as a result of a bonus issue, capitalisation or share split or decreases as a result of a reverse share split (consolidation of shares), the calculation of basic and diluted earnings per share should be adjusted for all the periods presented.

If these changes occur after the balance sheet date but before the date on which the financial statements are approved by the board of directors, the per share calculations for those financial statements and any prior period financial statements presented should be based on the new number of shares.

Disclosure

An enterprise should disclose the following:

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

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

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

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

Illustration 30

Net profit for the year 2012	*₹ 12,00,000*
Weighted average number of equity shares outstanding during the year 2012	*5,00,000 shares*
Average fair value of one equity share during the year 2012	*₹ 20.00*
Weighted average number of shares under option during the year 2012	*1,00,000 shares*
Exercise price for shares under option during the year 2012	*₹ 15.00*

Compute Basic and Diluted Earnings Per Share.

Solution

Computation of earnings per share

	Earnings ₹	Shares	Earnings/ Share ₹
Net profit for the year 2012	12,00,000		
Weighted average no. of shares during year 2012		5,00,000	
Basic earnings per share			2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value (100,000 x 15.00)/20.00		(75,000)	
Diluted earnings per share	12,00,000	5,25,000	2.29

2.8 AS 26 : Intangible Assets

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

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

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

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

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

Scope

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

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

b. Financial assets.

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

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

However, this Statement applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises.

This Statement also applies to:

(i) expenditure on advertising, training, start - up cost

(ii) Research and development activities

(iii) Right under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts

(iv) Patents, copyrights and trademarks

(v) goodwill

An asset is a resource:

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

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

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

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

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

a. The items traded within the market are homogeneous.

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

c. Prices are available to the public.

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

A financial asset is any asset that is:

a. Cash,

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

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

d. An ownership interest in another enterprise.

Intangible Assets

An intangible asset is

- an identifiable
- non-monetary asset

- without physical substance
- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

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

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

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

Identifiability

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

Control

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

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

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

Future Economic Benefits

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

Recognition and Initial Measurement of an Intangible Asset

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

a. It is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

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

An intangible asset should be measured initially at cost.

An enterprise should assess the probability of futue economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset

Separate Acquisition

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

Acquisition as part of an Amalgamation

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

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

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

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

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

Acquisition by way of a Government Grant

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

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

Internally Generated Intangible Assets

Internally generated goodwill should not be recognised as an asset.

To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into

- Research Phase &
- Development Phase

If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

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

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

Examples of research activities are:

a. Activities aimed at obtaining new knowledge.

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

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

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

Development Phase

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

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

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

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

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

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

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

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

Examples of development activities are:

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

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

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

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

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

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

Cost of an Internally Generated Intangible Asset

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

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

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

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

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

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

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

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

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

Recognition of an Expense

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

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

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

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

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

Subsequent Expenditure

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

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

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

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

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

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

Amortisation Period

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

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

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

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

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

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

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

Amortisation Method

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

Residual Value

Residual value is the amount, which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

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

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

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

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

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

Recoverability of the Carrying Amount-Impairment Losses

Impairment losses of intangible assets are calculated on the basis of AS 28. AS 28 "Impairment of Assets" is not covered under IPCC curriculum and will be discussed in the Final level of CA course.

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

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

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

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

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

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

Retirements and Disposals

An intangible asset should be derecognised (eliminated from the balance sheet) if

- disposed or
- when no future economic benefits are expected from its use.

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

Disclosure

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

1. The useful lives or the amortisation rates used.
2. The amortisation methods used.
3. The gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period.
4. A reconciliation of the carrying amount at the beginning and end of the period showing:

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

   II. Retirements and disposals.

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

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

   V Amortisation recognised during the period and

   VI Other changes in the carrying amount during the period.

Other Disclosures

The financial statements should also disclose:

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

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

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

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

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

Transitional Provisions

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

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

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

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

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

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

Illustration 31

ABC Ltd. developed know-how by incurring expenditure of ₹ 20 lakhs, The know-how was used by the company from 1.4.2005. The useful life of the asset is 10 years from the year of commencement of its use. The company has not amortised the asset till 31.3.2012. Pass Journal entry to give effect to the value of know-how as per Accounting Standard-26 for the year ended 31.3.2012.

Solution

Journal Entry

		₹	₹
Profit and Loss A/c (Prior period item)	Dr.	12,00,000	
Depreciation A/c	Dr.	2,00,000	

To Know-how A/c*		14,00,000
[Being depreciation of 7 years (out of which depreciation of 6 years charged as prior period item)]		

Illustration 32

The company had spent ₹ 45 lakhs for publicity and research expenses on one of its new consumer product, which was marketed in the accounting year 2011-2012, but proved to be a failure. State, how you will deal with the following matters in the accounts of U Ltd. for the year ended 31st March, 2012.

Answer

In the given case, the company spent ₹ 45 lakhs for publicity and research of a new product which was marketed but proved to be a failure. It is clear that in future there will be no related further revenue/benefit because of the failure of the product. Thus according to paras 41 to 43 of AS 26 'Intangible Assets', the company should charge the total amount of ₹ 45 lakhs as an expense in the profit and loss account.

Illustration 33

A company with a turnover of ₹ 250 crores and an annual advertising budget of ₹ 2 crores had taken up the marketing of a new product. It was estimated that the company would have a turnover of ₹ 25 crores from the new product. The company had debited to its Profit and Loss account the total expenditure of ₹ 2 crore incurred on extensive special initial advertisement campaign for the new product.

Is the procedure adopted by the company correct?

Answer

According to paras 55 and 56 of AS 26 'Intangible Assets', "expenditure on an intangible item should be recognised as an expense when it is incurred unless it forms part of the cost of an intangible asset". In the given case, advertisement expenditure of ₹ 2 crores had been taken up for the marketing of a new product which may provide future economic benefits to an enterprise by having a turnover of ₹ 25 crores. Here, no intangible asset or other asset is acquired or created that can be recognised. Therefore, the accounting treatment by the company of debiting the entire advertising expenditure of ₹ 2 crores to the Profit and Loss account of the year is correct.

---

* As per para 63 of AS 26 "Intangible Assets", there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

Illustration 34

Swift Ltd. acquired a patent at a cost of ₹ 80,00,000 for a period of 5 years and the product life-cycle is also 5 years. The company capitalized the cost and started amortizing the asset at ₹ 10,00,000 per annum. After two years it was found that the product life-cycle may continue for another 5 years from then. The net cash flows from the product during these 5 years were expected to be ₹ 36,00,000, ₹ 46,00,000, ₹ 44,00,000, ₹ 40,00,000 and ₹ 34,00,000. Find out the amortization cost of the patent for each of the years.

Solution

Swift Limited amortised ₹ 10,00,000 per annum for the first two years i.e. ₹ 20,00,000. The remaining carrying cost can be amortized during next 5 years on the basis of net cash flows arising from the sale of the product. The amortisation may be found as follows:

Year	*Net cash flows* ₹	*Amortization Ratio*	*Amortization Amount* ₹
I	-	0.125	10,00,000[2]
II	-	0.125	10,00,000
III	36,00,000	0.180	10,80,000
IV	46,00,000	0.230	13,80,000
V	44,00,000	0.220	13,20,000
VI	40,00,000	0.200	12,00,000
VII	34,00,000	0.170	10,20,000
Total	2,00,00,000	1.000	80,00,000

It may be seen from above that from third year onwards, the balance of carrying amount i.e., ₹ 60,00,000 has been amortized in the ratio of net cash flows arising from the product of Swift Ltd.

Note: The answer has been given on the basis that the patent is renewable and Swift Ltd. got it renewed after expiry of five years.

2.9 AS 29 : Provisions, Contingent Liabilities and Contingent Assets

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

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

ii. Those resulting from executory contracts;

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

[2] It has been assumed that the company had amortized the patent at ₹ 10,00,000 per annum in the first two years on the basis of economic benefits derived from the product manufactured under the patent.

iv. Those covered by another Accounting Standard.

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

Definitions

- ***Executory contracts*** are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent.
- **A *Provision*** is a liability which can be measured only by using a substantial degree of estimation.
- **A *Liability*** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- **An *Obligating event*** is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.
- **A *Contingent liability*** is:
  - (a) A possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or
  - (b) A present obligation that arises from past events but is not recognised because:
    - (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    - (ii) A reliable estimate of the amount of the obligation cannot be made.
- **A *Contingent asset*** is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise.
- ***Present obligation*** **-** an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.
- ***Possible obligation*** **-** an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

Present Obligation

An enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence. On the basis of such evidence:

(a) Where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) Where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability.

Past Event

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

Main features are:

- The liabilities to be recognised in an enterprise's balance sheet are those that exist at the balance sheet date.
- It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. *Examples:* Penalties or clean up costs for unlawful environmental damage.
- An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.
- Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted.

Probable Outflow of Resources Embodying Economic Benefits

For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Statement, an outflow of resources or other event is regarded as probable if the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote.

Reliable Estimate of the Obligation

In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability.

Contingent Liabilities

An enterprise should not recognise a contingent liability but should be disclosed.

A contingent liability is disclosed, unless the possibility of an outflow of resources embodying economic benefits is remote. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

Recognition:

Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The balance is recognized as a provision, except where no reliable estimate can be made.

Contingent Assets

Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise.

Recognition:

An enterprise should not recognise a contingent asset, since this may result in the recognition of income that may never be realised.

However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority.

Measurement

Best Estimate

The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The amount of a provision should not be discounted to its present value. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22.

The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

Future Events

Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

Expected Disposal of Assets

Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

Changes in Provisions

Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

Future operating losses do not meet the definition of a liability and the general recognition criteria, therefore provisions should not be recognised for future operating losses.

Restructuring

A restructuring is a programme that is planned and controlled by management and materially changes either:

i. The scope of a business undertaken be an enterprise; or

ii. The manner in which that business is conducted.

The following are examples of events that may fall under the definition of restructuring:

(a) Sale or termination of a line of business;

(b) The closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) Changes in management structure, for example, eliminating a layer of management; and

(d) Fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

A provision for restructuring costs is recognised only when the recognition criteria for provisions. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms.

A restructuring provision should include only the direct expenditures arising from the restructuring, which are those that are both:

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the enterprise.

A restructuring provision does not include such costs as:

(a) Retraining or relocating continuing staff;

(b) Marketing; or

(c) Investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

Identifiable future operating losses up to the date of a restructuring are not included in a provision.

As required by paragraph 44 of the satndard, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

1. For each class of provision, an enterprise should disclose:
   - The carrying amount at the beginning and end of the period;
   - Additional provisions made in the period, including increases to existing provisions;
   - Amounts used (i.e. incurred and charged against the provision) during the period; and
   - 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;

- 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
- 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:
   - An estimate of its financial effect,
   - An indication of the uncertainties relating to any outflow; and
   - The possibility of any reimbursement.
4. Where any information required for contingent liability is not disclosed because it is not practicable to do so, the fact should be stated properly.

Illustration 35

EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2014. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 2011-12 has been completed on 14th February, 2014 with a demand of ₹ 2.76 crore. The company paid the entire due under protest without prejudice to its right of appeal. The Company files its appeal before the appellate authority wherein the grounds of appeal cover tax on additions made in the assessment order for a sum of 2.10 crore.

(ii) The Company has entered into a wage agreement in May, 2014 whereby the labour union has accepted a revision in wage from June, 2013. The agreement provided that the hike till May, 2014 will not be paid to the employees but will be settled to them at the time of retirement. The company agrees to deposit the arrears in Government Bonds by September, 2014.

Answer

(i) Since the company is not appealing against the addition of ₹ 0.66 crore the same should be provided for in its accounts for the year ended on 31st March, 2014. The amount paid under protest can be kept under the heading 'Loans & Advances' and disclosed along with the contingent liability of ₹ 2.10 crore.

(ii) The arrears for the period from June, 2013 to March, 2014 are required to be provided for in the accounts of the company for the year ended on 31st March, 2014.

Miscellaneous Illustrations

Illustration 36

How would you deal with the following in the annual accounts of a company for the year ended 31st March, 2013?

(a) The company has to pay delayed cotton clearing charges over and above the negotiated price for taking delayed delivery of cotton from the Suppliers' Godown. Up to 2011-12, the company has regularly included such charges in the valuation of closing stock. This being in the nature of interest the company has decided to exclude it from closing stock valuation for the year 2011-12. This would result into decrease in profit by ₹ 7.60 lakhs

(b) Fuel surcharge is billed by the State Electricity Board at provisional rates. Final bill for fuel surcharge of ₹ 5.30 lakhs for the period October, 2005 to September, 2011 has been received and paid in February, 2012.

Solution

(a) Para 29 of AS 5 (Revised) 'Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies" states that a change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of an enterprise. Therefore the change in the method of stock valuation is justified in view of the fact that the change is in line with the recommendations of AS 2 (Revised) 'Valuation of Inventories' and would result in more appropriate preparation of the financial statements. As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements.

Also, appropriate disclosure of the change and the amount by which any item in the financial statements is affected by such change is necessary as per AS 1, AS 2 and AS 5. Therefore, the under mentioned note should be given in the annual accounts.

"In compliance with the Accounting Standards issued by the ICAI, delayed cotton clearing charges which are in the nature of interest have been excluded from the valuation of closing stock unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing stock as well as profit before tax for the year would have been higher by ₹ 7.60 lakhs."

(b) The final bill having been paid in February, 2012 should have been accounted for in the annual accounts of the company for the year ended 31st March, 2012. However it seems that as a result of error or omission in the preparation of the financial statements of prior period i.e., for the year ended 31st March 2012, this material charge has arisen in the current period i.e., year ended 31st March, 2013. Therefore it should be treated as 'Prior period item' as per para 16 of AS 5. As per para 19 of AS 5 (Revised), prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

It may be mentioned that it is an expense arising from the ordinary course of business. Although abnormal in amount or infrequent in occurrence, such an expense does not qualify an extraordinary item as per Para 10 of AS 5 (Revised). For better understanding, the fact that power bill is accounted for at provisional rates billed by the state electricity board and final adjustment thereof is made as and when final bill is received may be mentioned as an accounting policy.'

Illustration 37

In preparing the financial statements of R Ltd. for the year ended 31st March, 2013, you come across the following information. State with reasons, how you would deal with this in the financial statements:

The company invested 100 lakhs in April, 2013 in the acquisition of another company doing similar business, the negotiations for which had started during the financial year.

Solution

As it is stated in the question that financial statements for the year ended 31st March, 2013 are under preparation, the views have been given on the basis that the financial statements are yet to be completed and approved by the Board of Directors.

Para 3.2 of AS 4 (Revised) defines "Events occurring after the balance sheet date" as those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company. Accordingly, the acquisition of another company is an event occurring after the balance sheet date. However no adjustment to assets and liabilities is required as the event does not affect the determination and the condition of the amounts stated in the financial statements for the year ended 31st March, 2013. Applying para 15 which clearly states that/disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise, the investment of ₹ 100 lakhs in April, 2013 in the acquisition of another company should be disclosed in the report of the Board of Directors to enable users of financial statements to make proper evaluations and decisions.

Illustration 38

A Limited Company closed its accounting year on 30.6.13 and the accounts for that period were considered and approved by the board of directors on 20th August, 2013. The company was engaged in laying pipe line for an oil company deep beneath the earth. While doing the boring work on 1.9.2013 it had met a rocky surface for which it was estimated that there would be an extra cost to the tune of ₹ 80 lakhs. You are required to state with reasons, how the *event would be dealt with in the financial statements for the year ended 30.6.13.*

Solution

Para 3.2 of AS 4 (Revised) on Contingencies and Events Occurring after the Balance Sheet Date defines 'events occurring after the balance sheet date' as 'significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which financial statements are approved by the Board of Directors in the case of a company'. The given case is discussed in the light of the above mentioned definition and requirements given in paras 13-15 of the said AS 4 (Revised).

In this case the incidence, which was expected to push up cost became evident after the date of approval of the accounts. So that was not an 'event occurring after the balance sheet date'. However, this may be mentioned in the Directors' Report*.

Illustration 39

While preparing its final accounts for the year ended 31st March, 2013 a company made a provision for bad debts @ 5% of its total debtors. In the last week of February, 2013 a debtor for ₹ 2 lakhs had suffered heavy loss due to an earthquake; the loss was not covered by any insurance policy. In April, 2013 the debtor became a bankrupt. Can the company provide for the full loss arising out of insolvency of the debtor in the final accounts for the year ended 31st March, 2013?

Solution

As per paras 8.2 and 13 of Accounting Standard 4 on Contingencies and Events Occurring after the Balance Sheet Date, Assets and Liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist estimation of amounts relating to conditions existing at the balance sheet date.

So full provision for bad debt amounting to ₹ 2 lakhs should be made to cover the loss arising due to the insolvency in the Final Accounts for the year ended 31st March, 2013. It is because earthquake took place before the balance sheet date.

Had the earthquake taken place after 31st March, 2013, then mere disclosure required as per para 15, would have been sufficient.

Illustration 40

At the end of the financial year ending on 31st December, 2013, a company finds that there are twenty law suits outstanding which have not been settled till the date of approval of accounts by the Board of Directors. The possible outcome as estimated by the Board is as follows:

---

* *Such events, however, are disclosed in the financial statements instead of report of directors as per Exposure Draft on Limited Revision to AS 4. However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt.*

	Probability	Loss (₹)
In respect of five cases (Win)	*100%*	–
Next ten cases (Win)	*60%*	–
Lose (Low damages)	*30%*	*1,20,000*
Lose (High damages)	*10%*	*2,00,000*
Remaining five cases		
Win	*50%*	–
Lose (Low damages)	*30%*	*1,00,000*
Lose (High damages)	*20%*	*2,10,000*

Outcome of each case is to be taken as a separate entity. Ascertain the amount of contingent loss and the accounting treatment in respect thereof.

Solution

According to AS 29 'Provisions, Contingent Liabilities and Contingent Assets', contingent liability should be disclosed in the financial statements if following conditions are satisfied:

(i) There is a present obligation arising out of past events but not recognized as provision.

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

(iii) The possibility of an outflow of resources embodying economic benefits is also remote.

(iv) The amount of the obligation cannot be measured with sufficient reliability to be recognized as provision.

In this case, the probability of winning of first five cases is 100% and hence, question of providing for contingent loss does not arise. The probability of winning of next ten cases is 60% and for remaining five cases is 50%. As per AS 29, we make a provision if the loss is probable. As the loss does not appear to be probable and the possibility of an outflow of resources embodying economic benefits is not remote rather there is reasonable possibility of loss, therefore disclosure by way of note should be made. For the purpose of the disclosure of contingent liability by way of note, amount may be calculated as under:

Expected loss in next ten cases = 30% of ₹ 1,20,000 + 10% of ₹ 2,00,000

= ₹ 36,000 + ₹ 20,000 = ₹ 56,000

Expected loss in remaining five cases = 30% of ₹ 1,00,000 + 20% of ₹ 2,10,000

= ₹ 30,000 + ₹ 42,000 = ₹ 72,000

To disclose contingent liability on the basis of maximum loss will be highly unrealistic. Therefore, the better approach will be to disclose the overall expected loss of ₹ 9,20,000 (₹ 56,000 × 10 + ₹ 72,000 × 5) as contingent liability.

Illustration 41

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

(Accounting year 1.1.2012 – 31.12.2012)

Net Profit	:	*Year 2012 : ₹ 20,00,000*
	:	*Year 2013 : ₹ 30,00,000*
No. of shares outstanding prior to Right Issue	:	*10,00,000 shares*
Right Issue	:	*One new share for each four Out standing i.e., 2,50,000 shares.*
		Right Issue price – ₹ 20
		Last date of exercise rights – 31.3.2013.
Fair rate of one Equity share immediately prior to exercise of rights on 31.3.2013	:	*₹ 25*

Solution

Computation of Basic Earnings Per Share

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

	Year 2010 ₹	Year 2011 ₹
EPS for the year 2012 as originally reported		
$= \dfrac{\text{Net profit of the year attributable to equity shareholders}}{\text{Weighted average number of equity shares outstanding during the year}}$		
= (₹ 20,00,000 / 10,00,000 shares)	2.00	
EPS for the year 2012 restated for rights issue		
= [₹ 20,00,000 / (10,00,000 shares × 1.04*)]	1.92 (approx.)	
EPS for the year 2013 including effects of rights issue		
$\dfrac{₹\ 30,00,000}{(10,00,000 \text{ shares} \times 1.04 \times 3/12) + (12,50,000 \text{ shares} \times 9/12)}$		
$\dfrac{₹\ 30,00,000}{11,97,500 \text{ shares}}$		2.51 (approx.)

* Refer working note 2.

Working Notes:

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

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

$$= \frac{(₹\ 25 \times 10,00,000 \text{ shares}) + (₹\ 20 \times 2,50,000 \text{ shares})}{10,00,000 \text{ shares} + 2,50,000 \text{ shares}} = \frac{₹\ 3,00,00,000}{12,50,000 \text{ shares}} = ₹\ 24$$

2. *Computation of adjustment factor*

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

3

Advanced Issues in Partnership Accounts

Unit - 1 : Dissolution of Partnership Firms

Learning Objectives

After studying this unit, you will be able to:

- Go through the circumstances in which a partnership is dissolved.
- Understand that on dissolution of a partnership all assets are sold out and all liabilities are discharged. Learn the accounting technique relating to disposal of assets and payment of liabilities.
- Learn how to settle the partner's claims in case of surplus and how to raise money from partners in case of deficit.
- Deal with piecemeal distribution to partners of amount realized from assets net of liabilities.

1.1 Introduction

Apart from readjustment of rights of partners in the share of profit by way of change in the profit sharing ratio and admission of a new partner or for retirement/death of a partner, another important aspect of partnership accounts is how to close books of accounts in case of dissolution. In this Unit, we shall discuss the circumstances leading to dissolution of a partnership firm and accounting treatment necessary to close its books of accounts. Also we shall discuss the special problems relating to insolvency of partners and settlement of partnership's liabilities.

1.2 Circumstances Leading to Dissolution of Partnership

A partnership is dissolved or comes to an end on:

(a) the expiry of the term for which it was formed or the completion of the venture for which it was entered into;

(b) death of a partner;

(c) insolvency of a partner;

(d) retirement of a partner;

However, the partners or remaining partners (in case of death, insolvency or retirement) may continue to do the business. In such case there will be a new partnership but the firm will continue. When the business comes to an end then only it will be said that the firm has been dissolved.

A firm stands dissolved in the following cases:

(i) The partners agree that the firm should be dissolved;

(ii) All partners except one become insolvent;

(iii) The business becomes illegal;

(iv) In case of partnership at will, a partner gives notice of dissolution; and

(v) The court orders dissolution.

The court has the option to order dissolution of a firm in the following circumstances :

(a) Where a partner has become of unsound mind;

(b) Where a partner suffers from permanent incapacity;

(c) Where a partner is guilty of misconduct of the business;

(d) Where a partner persistently disregards the partnership agreement;

(e) Where a partner transfers his interest or share to a third party;

(f) Where the business cannot be carried on except at a loss; and

(g) Where it appears to be just and equitable.

1.3 Consequences of Dissolution

On the dissolution of a partnership, firstly, the assets of the firm, including goodwill, are realized. Then the amount realized, is applied first towards repayment of liabilities to outsiders and loans taken from partners; afterwards the capital contributed by partners is repaid and, if there is still surplus, it is distributed among the partners in their profit-sharing ratio.

Conversely, after payment of liabilities of the firm and repayment of loans from partners, if the assets of the firm left over are insufficient to repay in full the capital contributed by each partner, the deficiency is borne by the partners in their profit-sharing ratio.

According to the provisions contained in section 48 of the Partnership Act, upon dissolution of partnership, the mutual rights of the partners, unless otherwise agreed upon, are settled in the following manner:

(a) Losses including deficiencies of capital are paid, first out of profits, next out of capital and, lastly, if necessary, by the partners individually in the proportion in which they are entitled to share profits.

(b) The assets of the firm, including any sums contributed by the partners to make up deficiencies of capital have to be applied in the following manner and order:

(i) in paying the debts of the firm to third parties;

(ii) in paying to each partner rateably what is due to him from the firm in respect of advances as distinguished from capital;

(iii) in paying to each partner what is due to him on account of capital; and

(iv) the residue, if any, to be divided among the partners in the proportion in which they are entitled to share profits.

The death or retirement of a partner would not result in the dissolution of the partnership.

1.3.1 Dissolution before expiry of a fixed term

A partner who, on admission, pays a premium to the other partners with a stipulation that the firm will not be dissolved before the expiry of a certain term, will be entitled to a suitable refund if the firm is dissolved before the term has expired.

No claim in this respect will arise if:

(1) the firm is dissolved due to the death of a partner;

(2) the dissolution is mainly due to the partner's (claiming refund) own misconduct; and

(3) the dissolution is in pursuance of an agreement containing no provision for the return of the premium or any part of it. [Section 50]

The amount to be repaid will be such as is reasonable having regard to the terms upon which the admission was made and to the length of period agreed upon and that already expired. Any amount that becomes due will be borne by other partners in their profit- sharing ratio.

1.4 Closing of Partnership Books on Dissolution

We will illustrate the required journal entries to be made for closing the books of a firm with the example given below:

Balance Sheet of Fast and Quick as at Dec. 31, 2011

Liabilities		₹	*Assets*		₹
Sundry Creditors		20,000	Plant and Machinery		40,000
Fast's Loan		10,000	Patents		6,000
General Reserve		10,000	Stock		25,000
Capitals:			Sundry Debtors	19,000	
Fast	30,000		*Less:* Prov. for doubtful debts	(1,000)	18,000

Quick	25,000	55,000	Cash		6,000
		95,000			95,000

Fast and Quick share profits in the ratio of 3:2. On 1st January, 2012 the firm was dissolved. Fast took over the patents at a valuation of ₹ 5,000. The other assets realised as under:

	₹
Goodwill	15,000
Plant and Machinery	30,000
Stock	22,000
Sundry Debtors	18,500
Total	85,500

The Sundry Creditors were paid off at a discount of 5%. The expense amounted to ₹ 3,500. The steps to close the books are given below:

I. Open a **Realisation Account** and **transfer all assets** except cash in hand or at bank at book values. Realisation Account is debited and the various assets are credited and thus closed. It should be remembered that Sundry Debtors and Provisions for Bad Debts Accounts are two separate accounts and the gross amount of debtors should be transferred. In the above example the entry will be:

		₹	₹
Realisation Account	Dr.	90,000	
To Plant and Machinery Account			40,000
To Patents Account			6,000
To Stock Account			25,000
To Sundry Debtors			19,000
(Transfer of various assets to the debit side of Realisation Account)			

II. **Transfer of liabilities** to outsiders and provisions and reserves against assets (e.g., Provision for Doubtful Debts) to the credit side of Realisation account. The accounts of the liabilities and provisions will be debited and thus closed. The entry should be at book figures. The entry will be:

		₹	₹
Sundry Creditors Account	Dr.	20,000	
Provision for Doubtful Debts Account	Dr.	1,000	
To Realisation Account			21,000
(Transfer of liabilities to outsiders and provision against debtors to Realisation Account)			

Note: Accounts denoting accumulated losses or profits should not be transferred to the Realisation Account.

III. (i) The Realisation Account should be **credited with the actual amount realised by sale of assets**. This should take no note of the book figures. Of course, Cash (or Bank) Account will be debited. Thus:

	₹	₹
Cash Account Dr.	85,500	
To Realisation Account		85,500
(Amount realised by sale of various assets)		

(ii) If a **partner takes over an asset**, his Capital Account should be debited and Realisation Account credited with the value agreed upon, Thus:

	₹	₹
Fast's Capital Account Dr.	5,000	
To Realisation Account		5,000
(Patents taken over by Fast at ₹ 5,000)		

IV. **Expenses of dissolution** or realisation of assets are debited to the Realisation Account and credited to Cash Account. Thus

	₹	₹
Realisation Account Dr.	3,500	
To Cash Account		3,500
(Payment of Expenses)		

V. (i) The actual amount **paid to creditors** should be debited to the Realisation Account and Cash Account is credited:

	₹	₹
Realisation Account Dr.	19,000	
To Cash Account		19,000
(Payment of Sundry Creditors ₹ 20,000 less 5%)		

(ii) If any **liability is taken over by a partner**, his Capital Account should be credited and Realisation Account debited with the amount agreed upon.

VI. At this stage, the Realisation Account will show **profit or loss**. If the debit side is bigger, there is a loss; if the credit side is bigger, there is a profit. Profit or loss is transferred to the Capital Accounts of partners in the profit sharing ratio. In case of profit, Realisation Account is debited and Capital Accounts credited. The entry for loss is, naturally, reverse of this entry. The Realisation Account in the example given above shows a loss of ₹ 1,000 (see account below).

		₹	₹
Fast's Capital Account	Dr.	600	
Quick's Capital Account	Dr.	400	
To Realisation Account			1,000
(Transfer of loss to Capital Account in the ratio of 3:2)			

VII. **Partner's Loans** if any, should now be paid. The entry is to debit the Loan Account and credit Cash Account. Thus:

		₹	₹
Fast's Loan Account	Dr.	10,000	
To Cash Account			10,000
(Repayment of Fast's Loan)			

VIII. Any **reserve** of accumulated profit or loss lying in the books (as shown by the Balance Sheet) should be transferred to the Capital Account in the profit sharing ratio. Thus:

		₹	₹
General Reserve	Dr.	10,000	
To Fast's Capital Account			6,000
To Quick's Capital Account			4,000
(General Reserve transferred to Capital Account in the ratio of 3:2)			

IX. At this stage the Capital Accounts of partners will show how much amount is due to them or from them. The partner owing money to the firm will pay; Cash Account will be debited and his Capital Account credited and thus closed. Money owing to a partner will be paid to him; his Capital Account will be debited and the Cash Account credited. This will close the Capital Accounts as well as the Cash Account. The entry in the above example is seen in the Capital Accounts below:

		₹	₹
Fast's Capital Account	Dr.	30,400	
Quick's Capital Account	Dr.	28,600	
To Cash Account			59,000
(Amount paid to partners on Capital Account)			

Ledger Accounts

Plant and Machinery Account

2012		₹	2012		₹
Jan. 1	To Balance b/d	40,000	Jan. 1	By Realisation A/c - Transfer	40,000

Patents Accounts

2012		₹	2012		₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realisation A/c - Transfer	6,000

Stock Account

2012		₹	2012		₹
Jan. 1	To Balance b/d	25,000	Jan. 1	By Realisation A/c - Transfer	25,000

Sundry Debtors Account

2012		₹	2012		₹
Jan. 1	To Balance b/d	19,000	Jan. 1	By Realisation A/c - Transfer	19,000

Provision for Doubtful Debts Account

2012		₹	2012		₹
Jan. 1	To Realisation A/c Transfer	1,000	Jan. 1	By Balance b/d	1,000

Sundry Creditors Account

2012		₹	2012		₹
Jan. 1	To Realisation A/c Transfer	20,000	Jan. 1	By Balance b/d	20,000

Fast's Loan Account

2012		₹	2012		₹
Jan. 1	To Cash Account	10,000	Jan. 1	By Balance b/d	10,000

General Reserve Account

2012		₹		2012		₹
Jan. 1	To Capital Accounts			Jan. 1	By Balance b/d	10,000
	Fast	6,000				
	Quick	4,000	10,000			
			10,000			10,000

Realisation Account

2012		₹	2012		₹
Jan.	To Sundry Assets		Jan.	By Sundry Creditors	20,000
	Plant and Machinery	40,000		By Provision for Doubtful Debts	1,000
	Patents	6,000		By Cash Account-	85,500
	Stock	25,000		assets realised	
	Sundry Debtors	19,000		By Fast's Capital Account- patents	
	To Cash Account- Exp.	3,500		taken over	5,000
	To Cash Account-			By Loss to :	
	Creditors paid	19,000		Fast 600	
				Quick 400	1,000
		1,12,500			1,12,500

Cash Account

2012		₹		2012	₹
Jan. 1	To Balance b/d	6,000	Jan. 1	By Realisation A/c-Exp.	3,500
	To Realisation b/d	85,500	Jan. 1	By Realisation A/c- Creditors	19,000
			Jan. 1	By Fast's Loan Account	10,000
			Jan. 1	By Fast's Capital A/c	30,400
			Jan. 1	By Quick's Capital A/c	28,600
		91,500			91,500

Fast's Capital Account

2012		₹	2012		₹
Jan. 1	To Realisation A/c- Patents	5,000	Jan. 1	By Balance b/d	30,000
	To Realisation A/c-Loss	600	Jan. 1	By General Reserve	6,000
	To Cash Account	30,400			
		36,000			36,000

Quick's Capital Account

2012		₹	2012		₹
Jan. 1	To Realisation A/c-loss	400	Jan. 1	By Balance b/d	25,000
	To Cash Account	28,600		By General Reserve	4,000
		29,000			29,000

Note :

(1) If any of the assets is taken over by a partner at a value mutually agreed to by the partners,

debit the Partner's Capital Account and credit Realisation Account with the price of asset taken over.

(2) Pay off the liabilities, crediting cash and debiting the liability accounts, the difference between the book figure and the amount paid being transferred to the Realisation Account.

(3) Liabilities to outsiders may also be transferred to the Realisation Account. In that case, the amount paid in respect of the liabilities in cash should be debited to the Realisation Account, Cash Account being credited. If liability is taken over by a partner, Realisation Account should be debited and the Partners' Capital A/cs credited at the figure agreed upon.

(4) The balance of the Realisation Account will represent either the profit or loss on realisation. Divide it between the partners in the proportion in which they shared profits and losses. In the case of a loss, credit Realisation Account and debit various partners' Capital Accounts; follow the opposite course in the case of a profit.

(5) Pay off the partners' loans or advances which are separate from the capital (if any) contributed by them, after setting off against them any debit balance in the capital account of the concerned partner.

(6) The balance of the cash account at the end will be exactly equal to the balance of capital account, provided they are in credit; credit cash and debit the partners' capital account with the amount payable to them to close their accounts.

If the capital account of a partner is in debit, after his share of loss or profit has been adjusted therein, the firm will not have sufficient cash or assets to pay off the amounts due to the other partners, until the amount is repaid by the partner whose account is in debit. If however, the partner is insolvent, the amount will not be realised. In such a case, the deficiency may be borne by the solvent partners in their profit-sharing ratio or according to the principle settled in the well known case of *Garner* vs. *Murray*. In the latter case, the deficiency would be borne by the solvent partners in proportion to their capitals and not in the proportion in which they share profits and losses.

1.5 Consequences of Insolvency of a Partner

If a partner goes insolvent then the following are the consequences:

1. The partner adjudicated as insolvent ceases to be a partner.
2. He ceases to be a partner on the date on which the order of adjudication is made.
3. The firm is dissolved on the date of the order of adjudication unless there is a contract to the contrary.
4. The estate of the insolvent partner is not liable for any act of the firm after the date of the order of adjudication, and
5. The firm cannot be held liable for any acts of the insolvent partner after the date of the order of adjudication.

1.6 Loss Arising from Insolvency of a Partner

When a partner is unable to pay his debt due to the firm he is said to be insolvent and the share of loss is to be borne by other solvent partners in accordance with the decision in the English case of Garner vs. Murray.

According to this decision, solvent partners have to bear the loss due to insolvency of a partner and have to categorically put that the normal loss on realisation of assets to be borne by all partners (including insolvent partner) in the profit sharing ratio but a loss due to insolvency of a partner has to be borne by the solvent partners in the capital ratio.

The determination of capital ratio for this has been explained below. The provisions of the Indian Partnership Act are not contrary to Garner vs. Murray rule. However, if the partnership deed provides for a specific method to be followed in case of insolvency of a partner, the provisions as per deed should be applied.

Capital Ratio on Insolvency

- The partners are free to have either fixed or fluctuating capitals in the firm.
- If they are maintaining capitals at fixed amounts then all adjustments regarding their share of profits, interest on capitals, drawings, interest on drawings, salary etc. are done through Current Accounts, which may have debit or credit balances and insolvency loss is distributed in the ratio of fixed capitals.
- But if capitals are not fixed and all transactions relating to drawings, profits, interest, etc., are passed through Capital Accounts then Balance Sheet of the business shall not exhibit Current Accounts of the partners and capital ratio will be determined after adjusting all the reserves and accumulated profits to the date of dissolution, all drawings to the date of dissolution, all interest on capitals and on drawings to the date of dissolution but before adjusting profit or loss on Realisation Account.
- If some partner is having a debit balance in his Capital Account and is not insolvent then he cannot be called upon to bear loss on account of the insolvency of other partner.

Insolvency of all Partners

- When the liabilities of the firm cannot be paid in full out of the firm's assets as well as personal assets of the partners, then all the partners of the firm are said to be insolvent. Under such circumstances it is better not to transfer the amount of creditors to Realisation Account.
- Creditors may be paid the amount available including the amount contributed by the partners.
- The unsatisfied portion of creditor account is transferred to Capital Accounts of the partners in the profit sharing ratio. Then Capital Accounts are closed. In doing so first close the Partners' Capital Account which is having the worst position. The last account will be automatically closed.

Illustration 1

P, Q and R were partners sharing profits and losses in the ratio of 3 : 2 : 1, no partnership salary or interest on capital being allowed. Their balance sheet on 30th June, 2012 is as follows:

Liabilities		₹	Assets		₹
Fixed Capital			Fixed assets :		
P	20,000		Goodwill		40,000
Q	20,000		Freehold Property		8,000
R	10,000	50,000	Plant and Equipment		12,800
Current Accounts :			Motor Vehicle		700
P	500		Current Assets		
Q	9,000	9,500	Stock		3,900
Loan from P		8,000	Trade Debtors	2,000	
Trade Creditors		12,400	Less : Provision	(100)	1,900
			Cash at Bank		200
			Miscellaneous losses		
			R's Current Account		400
			Profit and Loss Account		12,000
		79,900			79,900

On 1st July, 2012 the partnership was dissolved. Motor Vehicle was taken over by Q at a value of ₹ 500 but no cash passed specifically in respect of this transaction. Sale of other assets realised the following amounts:

	₹
Goodwill	nil
Freehold Property	7,000
Plant and Equipment	5,000
Stock	3,000
Trade Debtors	1,600

Trade Creditors were paid ₹ 11,700 in full settlement of their debts. The costs of dissolution amounted to ₹ 1,500. The loan from P was repaid, P and Q were both fully solvent and able to bring in any cash required but R was forced into bankruptcy and was only able to bring 1/3 of the amount due.

You are required to show:

(a) Cash and Bank Account,

(b) Realisation Account, and

(c) Partners Fixed Capital Accounts (after transferring Current Accounts' balances).

Solution

Cash / Bank Account

		₹		₹
To Balance b/d		200	By Realisation A/c-Creditors	11,700
To Realisation A/c-			By Realisation A/c-Expenses	1,500
Freehold property		7,000	By P's Loan A/c	8,000
Plant and Equipment		5,000	By P's Capital A/c	14,200
Stock		3,000	By Q's Capital A/c	24,200
Trade Debtors		1,600		
To Capital Accounts:				
P	25,500			
Q	17,000			
R	300	42,800		
		59,600		59,600

Realisation Account

	₹			₹
To Goodwill	40,000	By Trade Creditors		12,400
To Freehold Property	8,000	By Provision for Bad Debts		100
To Plant and Equipment	12,800	By Bank :		
To Motor Vehicle	700	Freehold Property	7,000	
To Stock	3,900	Plant and Equip.	5,000	
To Sundry Debtors	2,000	Stock	3,000	
To Bank (Creditors)	11,700	Debtors	1,600	16,600
To Bank (Expenses)	1,500	By Q (Car)		500
		By Capital Accounts: (Loss)		
		P	25,500	
		Q	17,000	
		R	8,500	51,000
	80,600			80,600

Partners' Capital Accounts

		P ₹	Q ₹	R ₹		P ₹	Q ₹	R ₹
To	Current A/c (Transfer)	5,500*	—	2,400**	By Balance b/d	20,000	20,000	10,000
To	Realisation A/c (Loss)	25,500	17,000	8,500	By Current A/c (Transfer)	—	5,000***	—
To	Realisation A/c (Car)	—	500	—	By Bank	-	—	300
					By Bank (realization loss)	25,500	17,000	-
To	R's Capital A/c (Deficiency)	300	300	—				
To	Bank	14,200	24,200	—	By P & Q (Deficiency)	—	—	600
		45,500	42,000	10,900		45,500	42,000	10,900

Note:

1. P, Q and S will bring cash to make good their share of the loss on realization. In actual practice they will not be bringing any cash; only a notional entry will be made.
2. On following Garner Vs. Murray rule, solvent partners P and Q have to bear the loss due to insolvency of a partner R in their fixed capital ratio.

Illustration 2

Amal and Bimal are in equal partnership. Their Balance Sheet stood as under on 31st March, 2012 when the firm was dissolved:

	₹		₹
Creditors A/c	*4,800*	*Plant & Machinery*	*2,500*
Amal's Capital A/c	*750*	*Furniture*	*500*
		Debtors	*1,000*
		Stock	*800*
		Cash	*200*
		Bimal's drawings	*550*
	5,550		*5,550*

Current account balances have been arrived after adjusting profit and loss account debit balance as follows:

* ₹ 6,000 - ₹ 500 = ₹ 5,500

** ₹ 2,000 + ₹ 400 = ₹ 2,400

*** ₹ 9,000 - ₹ 4,000 = ₹ 5,000

The assets realised as under:

	₹
Plant & Machinery	*1,250*
Furniture	*150*
Debtors	*400*
Stock	*500*

The expenses of realisation amounted to ₹ 175. Amal's private estate is not sufficient even to pay his private debts, whereas Bimal's private estate has a surplus of ₹ 200 only.

Show necessary ledger accounts to close the books of the firm.

Solution

In the books of M/s Amal and Bimal

Realisation Account

	₹			₹
To Sundry Assets :		By Cash A/c :		
Plant & Machinery	2,500	Plant & Machinery	1,250	
Furniture	500	Furniture	150	
Debtors	1,000	Debtors	400	
Stock	800	Stock	500	2,300
Cash A/c-expenses	175	By Partners' Capital A/c		
		Loss on realisation (Bal.fig.)		
		Amal	1,337	
		Bimal	1,338	2,675
	4,975			4,975

Cash Account

	₹		₹
March 31, 2012		March 31, 2012	
To Balance b/d	200	By Realisation A/c- expenses	175
To Realisation A/c		By Sundry Creditors A/c (Bal.fig.)	2,525
- Sale of sundry assets	2,300		
To Bimal's Capital A/c	200		
	2,700		2,700

Sundry Creditors Account

	₹		₹
To Cash A/c	2,525	By Balance b/d	4,800
To Deficiency A/c-transfer (bal.fig.)	2,275		
	4,800		4,800

Partners' Capital Account

	Amal ₹	Bimal ₹		Amal ₹	Bimal ₹
To Balance b/f	—	550	By Balance b/f	750	—
To Realisation A/c			By Cash A/c	—	200
- loss	1,337	1,338	By Deficiency		
			A/c- transfer (bal.fig.)	587	1,688
	1,337	1,888		1,337	1,888

Deficiency Account

	₹		₹
To Partners' Capital A/c		By Sundry Creditors A/c	2,275
Amal	587		
Bimal	1,688		
	2,275		2,275

Illustration 3

A, B, C and D sharing profits in the ratio of 4:3:2:1 decided to dissolve their partnership on 31st March 2012 when their balance sheet was as under:

Liabilities		₹	*Assets*	₹
Creditors		*15,700*	*Bank*	*535*
Employees Provident Fund		*6,300*	*Debtors*	*15,850*
Capital Accounts :-			*Stock*	*25,200*
A	*40,000*		*Prepaid Expenses*	*800*
B	*20,000*	*60,000*	*Plant & Machinery*	*20,000*
			Patents	*8,000*
			C's Capital A/c	*3,200*
			D's Capital A/c	*8,415*
		82,000		*82,000*

Following information is given to you :-

1. *One of the creditors took some of the patents whose book value was ₹ 5,000 at a valuation of ₹ 3,200. Balance of the creditors were paid at a discount of ₹ 400.*

2 *There was a joint life policy of ₹ 20,000 (not mentioned in the balance sheet) and this was surrendered for ₹ 4,500.*

3 *The remaining assets were realised at the following values:- Debtors ₹ 10,800; Stock ₹ 15,600; Plant and Machinery ₹ 12,000; and Patents at 60% of their book-values. Expenses of realisation amounted ₹ 1,500.*

D became insolvent and a dividend of 25 paise in a rupee was received in respect of the firms claim against his estate. Prepare necessary ledger accounts.

Solution

Realisation Account

		₹			₹
To Sundry Assets :-			By Creditors		15,700
Debtors	15,850		By Employee's Provident Fund		6,300
Stock	25,200		By Bank A/c :-		
Prepaid Expenses	800		Joint Life Policy	4,500	
Plant & Machinery	20,000		Debtors	10,800	
Patents	8,000	69,850	Stock	15,600	
To Bank-Creditors: (₹ 15,700 – ₹ 3,200-₹ 400)		12,100	Plant and Machinery	12,000	
To Bank A/c Employee's (P.F)		6,300	Patents 60% of (₹ 8,000 – ₹ 5,000)	1,800	44,700
To Bank A/c (expenses)		1,500	By Loss transferred to :-		
			A's Capital A/c	9,220	
			B's Capital A/c	6,915	
			C's Capital A/c	4,610	
			D's Capital A/c	2,305	23,050
		89,750			89,750

Capital Accounts

	A ₹	B ₹	C ₹	D ₹		A ₹	B ₹	C ₹	D ₹
To Bal. b/d	—	—	3,200	8,415	By Bal. b/d	40,000	20,000	—	—
To Realisation A/c	9,220	6,915	4,610	2,305	By Bank (Realisation loss)	9,220	6,915	4,610	—
To D's Capital (Deficiency)	5,360	2,680	—	—	By Bank (Recovery)	—	—	—	2,680
To Bank	34,640	17,320	—	—	By A's Capital 2/3	—	—	—	5,360
					By B's Capital 1/3	—	—	—	2,680
					By Bank A/c		—	3,200	—
	49,220	26,915	7,810	10,720		49,220	26,915	7,810	10,720

Bank Account

	₹		₹
To Balance b/d	535	By Realisation A/c	12,100
To Realisation A/c	44,700	By Realisation A/c	6,300
To A's Capital A/c	9,220	By Realisation A/c	1,500
To B's Capital A/c	6,915	By A's Capital A/c	34,640
To D's Capital A/c	2,680	By B's Capital A/c	17,320
To C's Capital A/c (4,610 + 3,200)	7,810		
	71,860		71,860

Working Note :-

D's loss will be borne by A and B only as solvent partners having credit balance only has to bear the loss on account of insolvency. C will bring his share of loss in cash.

Illustration 4

M/s X, Y and Z who were in partnership sharing profits and losses in the ratio of 2:2:1 respectively, had the following Balance Sheet as at December 31, 2012:

Liabilities	*₹*	*₹*	*Assets*	*₹*	*₹*
Capital : X	*29,200*		*Fixed Assets*		*40,000*
Y	*10,800*		*Stock*		*25,000*
Z	*10,000*	*50,000*	*Book Debts*	*25,000*	
Z's Loan		*5,000*	*Less : Provision*	*(5,000)*	*20,000*
Loan from Mrs. X		*10,000*	*Cash*		*1,000*
Sundry Trade Creditors		*25,000*	*Advance to Y*		*4,000*
		90,000			*90,000*

The firm was dissolved on the date mentioned above due to continued losses. After drawing up the balance sheet given above, it was discovered that goods amounting to ₹ 4,000 have been purchased in November, 2012 and had been received but the purchase was not recorded in books.

Fixed assets realised ₹ 20,000; Stock ₹ 21,000 and Book Debt ₹ 20,500. Similarly, the creditors allowed a discount of 2% on the average. The expenses of realisation come to ₹ 1,080. X agreed to take over the loan of Mrs. X. Y is insolvent, and his estate is unable to contribute anything.

Give accounts to close the books; work according to the decision in Garner vs. Murray.

Solution

Realisation Account

	₹			₹
To Sundry		By Provision for Doubtful Debts		5,000
Fixed Assets (transfer)	40,000	By Cash		61,500
		(20,000+21,000+20,500)		
Stock	25,000	By Sundry Trade Creditors		
Book Debts	25,000	(Discount)		580
To Cash—Expenses	1,080	By Loss :X (2/5)	9,600	
		Y (2/5)	9,600	
		Z (1/5)	4,800	24,000
	91,080			91,080

Sundry Trade Creditors

	₹		₹
To Realisation A/c – Discount		By Balance b/d	25,000
@ 2% on ₹ 29,000	580	By Sundry Capital Accounts	
To Cash	28,420	(Purchase omitted)	4,000
	29,000		29,000

Z's Loan Account

	₹		₹
To Cash Account	5,000	By Balance b/d	5,000

Mrs. X's Loan Account

	₹		₹
To X's Capital A/c - transfer	10,000	By Balance b/d	10,000

Cash Account

	₹		₹
To Balance b/d	1,000	By Sundry Trade Creditors	28,420
To Realisation A/c-		By Realisation A/c - expenses	1,080
assets realised	61,500	By Z's Loan	5,000
To X's Capital A/c*	9,600	By X's Capital A/c	34,300

To Z's Capital A/c*	4,800	By Z's Capital A/c	8,100
	76,900		76,900

*X and Z bring these amounts to make good their share of the loss on realisation. In actual practice they will not be bringing any cash; only a notional entry will be made.

Capital Accounts

	X ₹	Y ₹	Z ₹		X ₹	Y ₹	Z ₹
To Sundry Trade Creditors-omission	1,600	1,600	800	By Balance b/d	29,200	10,800	10,000
To Balance c/d	27,600	9,200	9,200				
	29,200	10,800	10,000		29,200	10,800	10,000
To Advance	-	4,000	-	By Balance b/d	27,600	9,200	9,200
To Realisation A/c-loss	9,600	9,600	4,800	By Mrs. X's Loan	10,000	-	-
To Y's Capital A/c	3,300	-	1,100	By Cash (Realisation loss)	9,600	-	4,800
				By X's Capital A/c-		3,300	
To Cash	34,300	-	8,100	By Z's Capital A/c	-	1,100	-
	47,200	13,600	14,000		47,200	13,600	14,000

Note : Y's deficiency comes to ₹ 4,400 (difference in the two sides of his Capital Account); this has been debited to X and Z in the ratio of 27,600 : 9,200 *i.e.,* capital standing up just before dissolution but after correction of error committed while drawing up the accounts for 2012.

Illustration 5

'Thin', 'Short' and 'Fat' were in partnership sharing profits and losses in the ratio of 2:2:1.

On 30th September, 2012 their Balance Sheet was as follows :

Liabilities		₹	*Assets*	₹
Capital Accounts :			*Premises*	*50,000*
Thin	*80,000*		*Fixtures*	*1,25,000*
Short	*50,000*		*Plant*	*32,500*
Fat	*20,000*	*1,50,000*	*Stock*	*43,200*
Current Accounts :			*Debtors*	*54,780*
Thin	*29,700*			
Short	*11,300*			
Fat (Dr.)	*(14,500)*	*26,500*		
Sundry Creditors		*84,650*		
Bank Overdraft		*44,330*		
		3,05,480		*3,05,480*

'Thin' decides to retire on 30th September, 2012 and as 'Fat' appears to be short of private assets, 'Short' decides that he does not wish to take over Thin's share of partnership, so all three partners decide to dissolve the partnership with effect from 30th September, 2012. It then transpires that 'Fat' has no private assets whatsoever.

The premises are sold for ₹ 60,000 and the plant for ₹ 1,07,500. The fixtures realize ₹ 20,000 and the stock is acquired by another firm at book value less 5%. Debtors realise ₹ 45,900. Realisation expenses amount to ₹ 4,500.

The bank overdraft is discharged and the creditors are also paid in full.

You are required to write up the following ledger accounts in the partnership books following the rules in Garner vs. Murray:

(i) Realisation Account;

(ii) Partners' Current Accounts;

(iii) Partners' Capital Accounts showing the closing of the firm's books.

Solution

Realisation Account

	₹			₹
To Premises	50,000	By Sundry Creditors		84,650
To Plant	1,25,000	By Bank :		
To Fixtures	32,500	Premises	60,000	
To Stock	43,200	Plant	1,07,500	
To Debtors	54,780	Fixtures	20,000	
To Bank (Creditors)	84,650	Stock	41,040	
To Bank (Expenses)	4,500	Debtors	45,900	2,74,440
		By Loss on Realisation transferred to Partners' Current A/cs		
		Thin	14,216	
		Short	14,216	
		Fat	7,108	35,540
	3,94,630			3,94,630

Partners' Current Accounts

	Thin	Short	Fat		Thin	Short	Fat
	₹	₹	₹		₹	₹	₹
To Balance b/d	–	–	14,500	By Balance b/d	29,700	11,300	–
To Realisation	14,216	14,216	7,108	By Capital A/c			
To Capital A/c				Transfer	–	2,916	21,608

transfer	15,484	–	–				
	29,700	14,216	21,608		29,700	14,216	21,608

Partners' Capital Accounts

	Thin	*Short*	*Fat*		*Thin*	*Short*	*Fat*
	₹	₹	₹		₹	₹	₹
To Current A/c	–	2,916	21,608	By Balance b/d	80,000	50,000	20,000
To Fat's Capital A/c				By Current A/c			
Deficiency in the				(transfer)	15,484	–	–
ratio of 8:5	990	618	–	By Bank (Realisation loss)	14,216	14,216	
To Bank	1,08,710	60,682	–	By Thin & Short			
				Capital A/cs			1,608
	1,09,700	64,216	21,608		1,09,700	64,216	21,608

Working Notes:

(i) **Bank Account**

	₹		₹
To Realisation A/c	2,74,440	By Balance b/d	44,330
To Thin's Capital A/c	14,216	By Realisation A/c (Creditors)	84,650
To Short's Capital A/c	14,216	By Realisation A/c (Expenses)	4,500
		By Thin's Capital A/c	1,08,710
		By Short's Capital A/c	60,682
	3,02,872		3,02,872

(ii) Fat's deficiency has been by borne Thin & Short in the ratio of their fixed capitals i.e., 8:5 following the rule in *Garner vs. Murray.*

1.7 Piecemeal Payments

Generally, the assets sold upon dissolution of partnership are realised only in small instalments over a period of time. In such circumstances, the choice is either to distribute whatever is collected or to wait till the whole amount is collected. Usually, the first course is adopted. In order to ensure that the distribution of cash among the partners is in proportion to their interest in the partnership concern either of the two methods described below may be followed for determining the order in which the payment should be made.

1.7.1 Maximum Loss Method

Each instalment realised is considered to be the final payment *i.e.,* outstanding assets and claims are considered worthless and partners' accounts are adjusted on that basis each time when a distribution is made, following either *Garner* vs. *Murray* Rule or the profit-sharing ratio rule.

Illustration 6

The following is the Balance Sheet of A, B, C on 31st December, 2012 when they decided to dissolve the partnership:

Liabilities	*₹*	*Assets*	*₹*
Creditors	*2,000*	*Sundry Assets*	*48,500*
A's Loan	*5,000*	*Cash*	*500*
Capital Accounts :			
A	*15,000*		
B	*18,000*		
C	*9,000*		
	49,000		*49,000*

The assets realised the following sums in instalments:

I	*1,000*
II	*3,000*
III	*3,900*
IV	*6,000*
V	*20,100*
	34,000

The expenses of realisation were expected to be ₹ 500 but ultimately amounted to ₹ 400 only.

Show how at each stage the cash received should be distributed between partners. They share profits in the ratio of 2:2:1.

Solution

First of all, the following table will be constructed to show the amounts available for distribution among the various interests:

Statement showing Realisation and Distribution of Cash Payments

	Realisation ₹	*Creditors* ₹	*Partners' Loan* ₹	*Partners' Capitals* ₹
1. After taking into account	1,000	1,000	-	-

	cash balance and amount set aside for expenses				
2.		3,000	1,000	2,000	-
3.		3,900	-	3,000	900
4.		6,000	-	-	6,000
	Including saving in expenses	20,100	-	-	20,100
		34,000	2,000	5,000	27,000

To ascertain the amount distributable out of each instalment realised among the partners, the following table will be constructed:

Statement of Distribution on Capital Account

(1) Calculation to determine the mode of distribution of ₹ 900

	Total ₹	*A* ₹	*B* ₹	*C* ₹
Balance	42,000	15,000	18,000	9,000
Less: Possible loss, should remaining assets prove to be worthless	(41,100)	(16,440)	(16,440)	(8,220)
	+ 900	– 1,440	+ 1,560	+ 780
Deficiency of A's capital written off against those of B and C in the ratio of their capital, 18,000 : 9,000 (*Garner* vs. *Murray*)			(960)	(480)
Manner in which the first ₹ 900 should be distributed			+ 600	+ 300

(2) *Distribution of ₹ 6,000*

Balance after making payment of amount shown in step (1)	41,100	15,000	17,400	8,700
Less : Possible Loss assuming remaining asset to be valueless	(35,100)	(14,040)	(14,040)	(7,020)
Balance available and to be distributed	6,000	960	3,360	1,680

(3) *Distribution of ₹ 20,100*

Balance after making payment of				

amount shown in step (2)	35,100	14,040	14,040	7,020
Less : Possible loss, assuming remaining assets to be valueless	(15,000)	(6,000)	(6,000)	(3,000)
Manner of distribution of ₹ 20,100	20,100	8,040	8,040	4,020
Summary :				
Balance	42,000	15,000	18,000	9,000
Total amounts paid	27,000	9,000	12,000	6,000
Loss	15,000	6,000	6,000	3,000

1.7.2 Highest Relative Capital Method

According to this method, the partner who has the higher relative capital, that is, whose capital is greater in proportion to his profit-sharing ratio, is first paid off. This method is also called as proportionate capital method.

For determining the amount by which the capital of each partner is in excess of his relative capital, partners' capitals are first divided by figures that are in proportion to their profit-sharing ratio; the smallest quotient will indicate the basic capital. Having ascertained the partner who has the smallest basic capital, the amount of capital of other partners proportionate to the profit-sharing ratio of the basic capital is calculated. These may be called as their hypothetical capitals. The amount of hypothetical capital of each partner is then subtracted from the amount of his actual capital; the resultant figure will be the amount of excess capital held by him. By repeating the process once or twice, as may be necessary between the partners having excess capital, the amount by which the capital of each partner is in excess will be ascertained. The partner with the largest excess capital will be paid off first, followed by payment to the other or others who rank next to him until the capitals of partners are reduced to their profit-sharing ratio.

The illustration given above is now worked out according to this method.

	A	*B*	*C*
Capital	₹ 15,000	18,000	9,000
Profit-sharing ratio	2	2	1
Capital divided by the profit-sharing ratio	7,500	9,000	9,000
Proportionate Capital of B and C, taking A's capital as the base	₹ 15,000	15,000	7,500
Excess of actual over proportionate capital	₹ nil	3,000	1,500

This indicates that A should not get anything till ₹ 3,000 is paid to B and ₹ 1,500 is paid to C. Since capital of B and C are already according to their mutual profit-sharing ratio (2:1), they will share the available cash in this ratio.

After paying off creditors and A's loan, the available amount will be distributed as below in this method:

	Total	*A* ₹	*B* ₹	*C* ₹
Third Instalment	900	-	600	300
Fourth Instalment (*i*)	3,600	-	2,400	1,200
(*ii*)	2,400	960	960	480
Fifth Instalment	20,100	8,040	8,040	4,020
Total	27,000	9,000	12,000	6,000

Total payment made to each partner will, of course be same under both the methods.

Illustration 7

The partners A, B and C have called you to assist them in winding up the affairs of their partnership on 30th June, 2012. Their Balance Sheet as on that date is given below :

Liabilities	₹	*Assets*	₹
Sundry Creditors	*17,000*	*Cash at Bank*	*6,000*
Capital Accounts :		*Sundry Debtors*	*22,000*
A	*67,000*	*Stock in trade*	*14,000*
B	*45,000*	*Plant and Equipment*	*99,000*
C	*31,500*	*Loan-A*	*12,000*
		Loan-B	*7,500*
	1,60,500		*1,60,500*

(1) The partners share profit and losses in the ratio of 5:3:2

(2) Cash is distributed to the partners at the end of each month

(3) A summary of liquidation transactions are as follows:

July 2012

₹ 16,500 – collected from Debtors; balance is uncollectable.

₹ 10,000 – received from sale of entire stock.

₹ 1,000 – liquidation expenses paid.

₹ 8,000 – cash retained in the business at the end of the month.

August 2012

₹ 1,500 – liquidation expenses paid. As part payment of his Capital, C accepted a piece of equipment for ₹ 10,000 (book value ₹ 4,000).

₹ 2,500 – cash retained in the business at the end of the month.

September 2012

₹ 75,000 – received on sale of remaining plant and equipment.

₹ 1,000 – liquidation expenses paid. No cash retained in the business.

Required : Prepare a schedule of cash payments as of September 30, showing how the cash was distributed.

Solution

Statement showing distribution of cash

		Creditors	*Capitals*		
	₹	₹	*A (₹)*	*B (₹)*	*C (₹)*
Balance Due after loan (W.N.(i))		17,000	55,000	37,500	31,500
July					
Balance available	6,000				
Realisation less expenses and cash retained	17,500				
Amount available and paid	23,500	17,000	-	-	6,500
Balance due		—	55,000	37,500	25,000
August					
Opening balance	8,000				
Expenses paid and balance carried forward	4,000				
Available for distribution	4,000				
Cash paid to 'B' and Equipment given to C.			—	4,000	10,000
(Excess paid to 'C' ₹ 7,333)			55,000	33,500	15,000
September					
Opening balance	2,500				
Amount realised less expenses	74,000				
Amount paid to partners	76,500		41,500	25,400	9,600
			13,500	8,100	5,400

Working Note:

(i) **Highest Relative Capital Basis**

		A ₹	B ₹	C ₹
Scheme of payment for July				
Balance of Capital Accounts		67,000	45,000	31,500
Less : Loans		(12,000)	(7,500)	—
	A	55,000	37,500	31,500
Profit sharing ratio		5	3	2
Capital Profit sharing ratio		11,000	12,500	15,750
Capital in profit sharing ratio, taking A's capital as base	B	55,000	33,000	22,000
Excess of C's Capital and B's Capital (A-B)			4,500	9,500
Profit sharing ratio			3	2
Capital Profit sharing ratio			1,500	4,750
Capital in profit sharing ratio taking B's Capital as base			4,500	3,000
Excess of C's Capital over B				6,500

(ii) **Scheme of distribution of available cash:**

	A	*B*	*C*
	₹	₹	₹
Scheme of payment for September			
Balance of Capital Accounts ***(A)***	55,000	33,500	15,000
Profit sharing ratio	5	3	2
Capital/Profit sharing ratio	11,000	11,167	7,500
Capital in profit sharing ratio taking C's capital as base ***(B)***	37,500	22,500	15,000
Excess of A's capital and B's capital ***(A-B)***	17,500	11,000	-
Profit sharing ratio	5	3	
Capital in profit sharing ratio	3,500	3,667	
Capital in profit sharing ratio taking A's capital as base	17,500	10,500	-
Excess of B's capital over A's capital	–	500	–

Payment ₹ 500 ***(C)***	-	(500)	-
Balance of Excess	17,500	10,500	
Payment ₹ 28,000 ***(D)***	(17,500)	(10,500)	-
Balance ***[A-C-D]***	37,500	22,500	15,000
Payment (₹ 76,500 – ₹ 28,500) ₹ 48,000 ***(D)***	(24,000)	(14,400)	(9,600)
Loss	13,500	8,100	5,400
Total Payment ₹ 76,500 ***[A+C+D]***	41,500	25,400	9,600

Illustration 8

The firm of LMS was dissolved on 31.3.2012, at which date its Balance Sheet stood as follows:

Liabilities	*₹*	*Assets*	*₹*
Creditors	*2,00,000*	*Fixed Assets*	*45,00,000*
Bank Loan	*5,00,000*	*Cash and Bank*	*2,00,000*
L's Loan	*10,00,000*		
Capital			
L	*15,00,000*		
M	*10,00,000*		
S	*5,00,000*		
	47,00,000		*47,00,000*

Partners share profits equally. A firm of Chartered Accountants is retained to realise the assets and distribute the cash after discharge of liabilities. Their fees which include all expenses is fixed at ₹ 1,00,000. No loss is expected on realisation since fixed assets include valuable land and building.

Realisations are:

S.No.	*Amount in ₹*
1	*5,00,000 (including cash and bank*
2	*15,00,000*
3	*15,00,000*
4	*30,00,000*
5	*30,00,000*

The Chartered Accountant firm decided to pay off the partners in 'Higher Relative Capital Method'. You are required to prepare a statement showing distribution of cash with necessary workings.

Solution

In the Books of M/s LMS
Statement of Piecemeal Distribution (Under Higher Relative Capital method)

Particulars	*Amount Available*	*Creditors*	*Bank Loan*	*L's loan*	*Capital A/cs*		
					L	*M*	*S*
	₹	₹	₹	₹	₹	₹	₹
Balance due		2,00,000	5,00,000	10,00,000	15,00,000	10,00,000	5,00,000
1st Instalment (including cash and bank balances)	5,00,000						
Less: Liquidator's Expenses and fee	(1,00,000)						
	4,00,000						
Less: Payment to Creditors and repayment of Bank Loan in the ratio of 2:5	(4,00,000)	(1,14,286)	(2,85,714)	–	–	–	–
Balance Due	–	85,714	2,14,286	10,00,000	15,00,000	10,00,000	5,00,000
2nd Instalment	15,00,000						
Less: Payment to Creditors and repayment of bank loan in full settlement	(3,00,000)	(85,714)	(2,14,286)	–	–	–	–
Balance Due	12,00,000	Nil	Nil	10,00,000	15,00,000	10,00,000	5,00,000
Less: Repayment of L's Loan	(10,00,000)			(10,00,000)	–	–	–
Balance Due	2,00,000			-	15,00,000	10,00,000	5,00,000
Less: Payment to Mr. L towards relative higher capital (W.N. 1)	(2,00,000)				(2,00,000)	–	–
Balance Due	Nil			Nil	13,00,000	10,00,000	5,00,000
3rd Instalment	15,00,000						
Less: Payment to Mr. L towards higher relative capital (W.N. 2)	(3,00,000)				(3,00,000)	–	–

Balance Due	12,00,000				10,00,000	10,00,000	5,00,000
Less: Payment to Mr. L & Mr. M towards excess capital (W.N. 1&2)	(10,00,000)				(5,00,000)	(5,00,000)	–
Balance Due	2,00,000				5,00,000	5,00,000	5,00,000
Less: Payment to all the partners equally	(2,00,000)				(66,667)	(66,667)	(66,666)
Balance due	Nil				4,33,333	4,33,333	4,33,334
4th Instalment	30,00,000						
Less: Payment to all the partners equally	(30,00,000)				(10,00,000)	(10,00,000)	(10,00,000)
Realisation profit credited to Partners					5,66,667	5,66,667	5,66,666
5th Instalment	30,00,000						
Less: payment to all partners equally	(30,00,000)				10,00,000	10,00,000	10,00,000
Realisation profit credited to partners					15,66,667	15,66,667	15,66,666

Working Notes:

(i) Scheme of payment of surplus amount of ₹ 2,00,000 out of second Instalment:

	Capital A/cs		
	L ₹	*M* ₹	*S* ₹
Balance (i)	15,00,000	10,00,000	5,00,000
Profit sharing ratio (ii)	1	1	1
Capital taking S's Capital (iii)	5,00,000	5,00,000	5,00,000
Excess Capital (iv) = (i) – (iii)	10,00,000	5,00,000	
Profit Sharing Ratio	1	1	
Excess capital taking			
M's Excess Capital as base (v)	5,00,000	5,00,000	
Higher Relative Excess (iv) – (iv)	5,00,000		

So, Mr. L should get ₹ 5,00,000 first which will bring down his capital account balance from ₹ 15,00,000 to ₹ 10,00,000. Accordingly, surplus amounting to ₹ 2,00,000 will be paid to Mr. L towards higher relative capital.

(ii) Scheme of payment of ₹ 15,00,000 realised in 3rd Instalment:

- Payment of ₹ 3,00,000 will be made to Mr. L to discharge higher relative capital. This makes the higher capital of both Mr. L and Mr. M ₹ 5,00,000 as compared to capital of Mr. S.
- Payment of ₹ 5,00,000 each of Mr. L & Mr. M to discharge the higher capital.
- Balance ₹ 2,00,000 equally to L, M and S, i.e., ₹ 66,667 ₹ 66,667 and ₹ 66,666 respectively.

Illustration 9

Daksh Associates is a reputed firm. On account of certain misunderstanding between the partners, it was decided to dissolve the firm as on 31st December, 2011. Their Balance Sheet as on 31st December, 2011 was follows:

Liabilities		*₹*	*Assets*	*₹*
Capitals:			*Land and Buildings*	*7,00,000*
Daksh	*3,00,000*		*Other Fixed Assets*	*3,00,000*
Yash	*2,00,000*		*Stock in Trade*	*2,00,000*
Siddhart (Minor)	*1,00,000*		*Debtors*	*4,00,000*
		6,00,000	*Bills Receivable*	*1,50,000*
Trade Loans		*3,00,000*	*Goodwill*	*30,000*
Bank Overdraft		*3,00,000*	*Cash*	*20,000*
Other Loans		*2,00,000*		
Creditors		*2,00,000*		
Siddhart's Loan		*2,00,000*		
		18,00,000		*18,00,000*

It was decided that Mr. Daksh shall be in-charge of Realisation. He shall set apart ₹ 10,000 towards expenses. He shall be paid a remuneration of 5 percent on the amounts distributed to the partners towards their contribution other than loans. Assets realized are as under:

		₹
1-1-2012	*Debtors*	*3,50,000*
15-1-2012	*Fixed Assets*	*4,00,000*
1-2-2012	*Debtors*	*50,000*
15-2-2012	*Bills Receivable*	*1,40,000*
1-3-2012	*Fixed Assets*	*50,000*
15-3-2012	*Land and Buildings*	*8,00,000*

Prepare a statement showing how the money received on various dates will be distributed assuming:

(a) The actual expenses of realization amounted to ₹ 20,005.

(b) The firm is solvent.

(c) The profit sharing ratio was as under:

	Profit	Loss
Daksh	2	1
Yash	2	1
Siddhart	1	Nil
	5	2

(d) The final dissolution is made on 15th March, 2012

Solution

It is assumed that trade loans, bank overdraft, other loans and creditors have equal priority at the time of payment. Therefore, they all have been paid in the ratio of their dues outstanding.

Particulars		Trade Loans ₹	Bank Overdraft ₹	Other Loans ₹	Creditors ₹	Siddhart's Loan ₹	Daksh's Capital ₹	Yash's Capital ₹	Siddhart's Capital ₹
Amount due		3,00,000	3,00,000	2,00,000	2,00,000	2,00,000	3,00,000	2,00,000	1,00,000
Cash in hand	20,000								
Less: Amount kept for realization expenses	(10,000)								
	10,000								
Less: Distributed among outsiders (3:3:2:2)	(10,000)	(3,000)	(3,000)	(2,000)	(2,000)	-	-	-	-
Balance Due	Nil	2,97,000	2,97,000	1,98,000	1,98,000	2,00,000	3,00,000	2,00,000	1,00,000
Debtors realised on 1-1-2012	3,50,000								
Less: Distributed among outsiders (3:3:2:2)	(3,50,000)	(1,05,000)	(1,05,000)	(70,000)	(70,000)	-	-	-	-
Balance Due	Nil	1,92,000	1,92,000	1,28,000	1,28,000	2,00,000	3,00,000	2,00,000	1,00,000
Fixed Assets realized on 15-1-2012	4,00,000								
Less: Distributed among outsiders (3:3:2:2)	(4,00,000)	(1,20,000)	(1,20,000)	(80,000)	(80,000)	-	-	-	-
Balance Due	Nil	72,000	72,000	48,000	48,000	2,00,000	3,00,000	2,00,000	1,00,000
Debtors realized on 1-2-2012	50,000								
Less: Distributed among									

outsiders (3:3:2:2)	(50,000)	(15,000)	(15,000)	(10,000)	(10,000)	-	-	-	-
Balance Due	Nil	57,000	57,000	38,000	38,000	2,00,000	3,00,000	2,00,000	1,00,000
Bills Receivable realised on 15-2-2012	1,40,000								
Less: Distributed among outsiders (3:3:2:2)	(1,40,000)	(42,000)	(42,000)	(28,000)	(28,000)	-	-	-	-
Balance Due	Nil	15,000	15,000	10,000	10,000	2,00,000	3,00,000	2,00,000	1,00,000
Fixed Assets realized on 1-3-2012	50,000								
Less: Distributed among outsiders (3:3:2:2)	(50,000)	(15,000)	(15,000)	(10,000)	(10,000)	-	-	-	-
Balance Due	Nil	-	-	-	-	2,00,000	3,00,000	2,00,000	1,00,000
Land and Building realised on 15-3-2012	8,00,000								
Less: Additional payment of realization expenses (20,005 – 10,000)	(10,005)								
	7,89,995								
Less: Payment of Siddhart's Loan	(2,00,000)					(2,00,000)	-	-	-
Amount available for partners' Capital	5,89,995					-	3,00,000	2,00,000	1,00,000
Less: Daksh's Commission (i.e. $5,89,995 \times \frac{5}{105}$)									

	(28,095)								
	5,61,900								
Less: Siddhart's Capital is paid first because he will not share any loss on account of being minor partner	(1,00,000)						____	____	(1,00,000)
	4,61,900						3,00,000	2,00,000	-
Less: Paid to Daksh to make his capital equal to that of Yash	(1,00,000)						(1,00,000)	____	
	3,61,900						2,00,000	2,00,000	-
Less: Distributed equally between Daksh and Yash	(3,61,900)						(1,80,950)	(1,80,950)	
Balance Due							19,050	19,050	Nil*

*Siddhart will get 1/5 share (i.e., share of profit) of what remains after paying ₹ 19,050 to each Daksh and Yash out of the proceeds of stock-in trade. If stock does not realize any amount, then amount unpaid to Daksh and Yash will become loss on realization. Siddhart has been paid first because he is not to share any loss on realization.

1.8 Issues Related to Accounting in Limited Liability Partnerships

The Limited Liability Partnerships (LLPs) in India were introduced by Limited Liability Partnership Act, 2008 which lay down the law for the formation and regulation of Limited Liability Partnerships.

Definitions :

Section 2 of the Limited Liability Partnership (LLPs) Act, 2008 defines the following terms as:

"limited liability partnership" means a partnership formed and registered under this Act;

"limited liability partnership agreement" means any written agreement between the partners of the limited liability partnership or between the limited liability partnership and its partners which determines the mutual rights and duties of the partners and their rights and duties in relation to that limited liability partnership;

"foreign limited liability partnership" means a limited liability partnership formed, incorporated or registered outside India which establishes a place of business within India.

"business" includes every trade, profession, service and occupation;

"**designated partner"** means any partner designated as such pursuant to section 7 of the Act;

"partner", in relation to a limited liability partnership, means any person who becomes a partner in the limited liability partnership in accordance with the limited liability partnership agreement;

Nature of Limited Liability Partnership

(1) A limited liability partnership is a body corporate formed and incorporated under this Act and is a legal entity separate from that of its partners.

(2) A limited liability partnership shall have perpetual succession.

(3) Any change in the partners of a limited liability partnership shall not affect the existence, rights or liabilities of the limited liability partnership.

Non-applicability of the Indian Partnership Act, 1932

Save as otherwise provided, the provisions of the Indian Partnership Act, 1932 shall not apply to a limited liability partnership.

Minimum number of partners

As per section 5 of the LLP Act, any individual or body corporate may be a partner in a limited liability partnership:

Provided that an individual shall not be capable of becoming a partner of a limited liability partnership, if-

(a) he has been found to be of unsound mind by a Court of competent jurisdiction and the finding is in force;

(b) he is an undischarged insolvent; or

(c) he has applied to be adjudicated as an insolvent and his application is pending

As per section 6 of the LLP Act, every limited liability partnership shall have at least two partners.

If at any time the number of partners of a limited liability partnership is reduced below two and the limited liability partnership carries on business for more than six months while the number is so reduced, the person, who is the only partner of the limited liability partnership during the time that it so carries on business after those six months and has the knowledge of the fact that it is carrying on business with him alone, shall be liable personally for the obligations of the limited liability partnership incurred during that period.

Designated partners

As per Section 7 of the LLP Act, every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be a resident in India:

Provided that in case of a limited liability partnership in which all the partners are bodies corporate or in which one or more partners are individuals and bodies corporate, at least two individuals who are partners of such limited liability partnership or nominees of such bodies corporate shall act as designated partners.

Explanation.-For the purposes of this section, the term "resident in India" means a person who has stayed in India for a period of not less 182 days during the immediately preceding one year.

Subject to the provisions of sub-section (1),

(1) if the incorporation document-

   (a) specifies who are to be designated partners, such persons shall be designated partners on incorporation; or

   (b) states that each of the partners from time to time of limited liability partnership is to be designated partner, every such partner shall be a designated partner;

(2) any partner may become a designated partner by and in accordance with the limited liability partnership agreement and a partner may cease to be a designated partner in accordance with limited liability partnership agreement.

(3) An individual shall not become a designated partner in any limited liability partnership unless he has given his prior consent to act as such to the limited liability partnership in such form and manner as may be prescribed.

(4) Every limited liability partnership shall file with the registrar the particulars of every individual who has given his consent to act as designated partner in such form and manner as may be prescribed within thirty days of his appointment.

(5) An individual eligible to be a designated partner shall satisfy such conditions and requirements as may be prescribed.

Liabilities of designated partners

As per Section 8 of LLP Act, unless expressly provided otherwise in this Act, a designated partner shall be-

(a) responsible for the doing of all acts, matters and things as are required to be done by the limited liability partnership in respect of compliance of the provisions of this Act including filing of any document, return, statement and the like report pursuant to the provisions of this Act and as may be specified in the limited liability partnership agreement; and .

(b) liable to all penalties imposed on the limited liability partnership for any contravention of those provisions.

Changes in designated partners

A limited liability partnership may appoint a designated partner within thirty days of a vacancy arising for any reason and provisions of sub-section (4) and sub-section (5) of section 7 shall apply in respect of such new designated partner:

Provided that if no designated partner is appointed, or if at any time there is only one designated partner, each partner shall be deemed to be a designated partner.

Distinction between an ordinary partnership firm and an LLP

	Key Elements	Partnerships	LLPs
1	Applicable Law	Indian Partnership Act 1932	The Limited Liability Partnerships Act, 2008
2	Registration	Optional	Compulsory with ROC
3	Creation	Created by an Agreement	Created by Law
4	Body Corporate	No	Yes
5	Separate Legal Entity	No	Yes
6	Perpetual Succession	Partnerships do not have perpetual succession	It has perpetual succession and individual partners may come and go
7	Number of Partners	Minimum 2 and Maximum 20 (subject to 10 for banks)	Minimum 2 but no maximum limit

8	Ownership of Assets	Firm cannot own any assets. The partners own the assets of the firm	The LLP as an independent entity can own assets
9	Liability of Partners / Members	Unlimited: Partners are severally and jointly liable for actions of other partners and the firm and their liability extends to personal assets	Limited to the extent of their contribution towards LLP except in case of intentional fraud or wrongful act of omission or commission by a partner.
10	Principal Agent Relationship	Partners are the agents of the firm and of each other	Partners are agents of the firm only and not of other partners

Formation of LLP

Two or more persons associated for the purpose of carrying on a lawful business with a view to earn profits may subscribe their names to an incorporation document and file the same with the Registrar of the state in which the Registered Office of the LLP is to be situated, in such manner with such fees as may be prescribed along with a statement in the prescribed form made by an advocate, a company secretary or a chartered accountant or a cost accountant that all the requirements of the LLP Act 2008 and the rules made there under have been complied with.

Limitation of Liability of an LLP and its partners

- Under section 27 (3) of the LLP Act, 2008 an obligation of an LLP arising out of a contract or otherwise, shall be solely the obligation of the LLP;
- The Liabilities of an LLP shall be met out of the properties of the LLP;
- Under section 28 (1) a partner is not personally liable, directly or indirectly, for an obligation referred to in Section 27 (3) above, solely by reason of being a partner in the LLP;
- Section 27 (1) states that an LLP is not bound by anything done by a partner in dealing with a person, if:
  - The partner does not have the authority to act on behalf of the LLP in doing a particular act; and
  - The other person knows that the partner has no authority or does not know or believe him to be a partner in the LLP
- Under section 30 (1) the liability of the LLP and the partners perpetrating fraudulent dealings shall be unlimited for all or any of the debts or other liabilities of the LLP.

Financial Disclosures & Returns

Under section 34 (1) every LLP shall maintain such proper books of accounts as may be prescribed relating to its affairs for each year of its existence on cash basis or accrual basis and according to the double entry system of accounting and shall maintain the same at its registered office for such period as may be prescribed;

Section 34 (2): Every LLP shall within six months of the end of each financial year prepare a Statement of Account and Solvency for the said financial year as at the last day of the said financial year, in such form as may be prescribed, and such statement shall be signed by the designated partners of the LLP;

Section 34 (3): Every LLP shall file within the prescribed time, the Statement of Account and Solvency with the Registrar every year in such form and manner and accompanied by such fee as may be prescribed;

The accounts of an LLP must be audited in accordance with such rules as may be prescribed.

Under Section 35 (1) of the LLP Act every LLP is required to file an Annual Return which is duly authenticated with the registrar within sixty days of the closure of its financial year in such form and manner and with such fees as may be prescribed.

Assignment and Transfer of Partnership Rights

The rights of a partner to the share of profits and losses of an LLP and to receive distribution in accordance with the LLP Agreement are transferable wholly or in part;

The transfer of any right by a partner as above does not by itself cause the disassociation of the partner or a dissolution or winding up of the LLP;

Similarly the transfer of the right as above does not entitle the transferee to participate in the management or the conduct of activities of the LLP, or give access to any information concerning the transactions of the LLP.

Conversion of firm into Limited Liability Partnership

Section 55 of LLP Act: A firm may convert into a LLP in accordance with the provisions of the Act and the Second Schedule to the Act.

Section 56 of LLP Act: A private limited company may convert into an LLP in accordance with the provisions of the Act and the Third Schedule to the Act.

Section 57 of LLP Act: An unlisted public limited company may convert into an LLP in accordance with the provisions of the Act and the Fourth Schedule to the Act.

Winding up and Dissolution

- Under section 63 of the LLP Act, 2008 an LLP may be wound up voluntarily or by the Tribunal and such LLP so wound up may be dissolved
- Under section 64 and LLP may be wound up by the Tribunal:

- If the LLP decides that it should be wound up by the Tribunal;
- If for a period of more than six months, the number of partners of the LLP is reduced below two;
- If the LLP is unable to pay its debts;
- If the LLP has acted against the interests of the integrity and sovereignty of India, the security of the state or public order;
- If the LLP has defaulted in the filing of the Statement of Account and Solvency with the Registrar for five consecutive financial years;
- If the Tribunal is of the opinion that it is just and equitable that the LLP be wound up.

Summary

- Reasons for which a partnership could be dissolved are
  - expiry of term for which its was formed
  - death of a partner
  - insolvency of a partner
  - retirement of a partner.
- Reasons when a firm stands dissolved
  - when partners mutually decide to dissolve
  - partners except one becomes insolvent
  - business becomes illegal
  - if partnership is at will any partner can give notice for dissolution
  - Court orders.
- On dissolution assets are realized and all liabilities are paid off

  (*if any liability remains unpaid then it is to be realized from partners in their profit sharing ratio*).
- Piecemeal distribution involves either of two methods
  - Maximum loss method
  - Highest relative capital method.

Unit – 2 : Amalgamation, Conversion and Sale of Partnership Firms

Learning Objectives

After studying this unit, you will be able to :

- Understand the procedure for amalgamation of partnership firms.
- Learn the accounting treatment when a partnership firm is converted in the form of a company.
- Distribute the shares received as purchase consideration among the partners.

2.1 Amalgamation of Partnership Firms

When two or more partnership firms are amalgamated, the books of old firm are closed and books of the new firm are opened.

The accounting procedures for the same are:

2.1.1 Closing the books of old firm

(a) Each firm should prepare a **Revaluation Account** relating to its own assets and liabilities and transfer the balance to the partners' capital accounts in the profit-sharing ratio.

(b) Entries for **raising goodwill** should be passed.

(c) **Assets and liabilities not taken over** by the new firm should be transferred to the capital accounts of partners in the ratio of their capitals.

(d) The **new firm** should be debited with the difference between the value of assets and liabilities taken over by it; the assets should be credited and liabilities debited.

(e) **Partners' capital accounts** should be transferred to the new firm's account;

2.1.2 Opening the books of the new firm

Debit assets taken out at the agreed values

Credit the liabilities taken over, and

Credit individual partner's capital accounts with the closing balances in the erstwhile firm.

When one firm is merged with another existing firm, entries will be in the pattern of winding up in the books of the firm which has ceased to exist. The other firm will record the transaction as that of a business purchase.

Illustration 1

B and S are partners of S & Co. sharing profits and losses in the ratio of 3:1. S and T are partners of T & Co. sharing profits and losses in the ratio of 2:1.

On 31st October, 2012, they decided to amalgamate and form a new firm M/s. BST & Co.

wherein B, S and T would be partners sharing profits and losses in the ratio of 3:2:1.

Their balance sheets on that date were as under:

Liabilities	S & Co. ₹	T & Co. ₹	Assets	S & Co. ₹	T & Co. ₹
Due to X & Co.	40,000	–	Cash in hand	10,000	5,000
Due to S & Co.	–	50,000	Cash at bank	15,000	20,000
Other Creditors	60,000	58,000	Due from T & Co.	50,000	–
Reserves	25,000	50,000	Due from X & Co.	–	30,000
Capitals			Other Debtors	80,000	1,00,000
B	1,20,000	–	Stock	60,000	70,000
S	80,000	1,00,000	Furniture	10,000	3,000
T	–	50,000	Vehicles	–	80,000
			Machinery	75,000	–
			Building	25,000	
	3,25,000	3,08,000		3,25,000	3,08,000

The amalgamated firm took over the business on the following terms :

(a) *Goodwill of S & Co. was worth ₹ 60,000 and that of T & Co. ₹ 50,000. Goodwill account was not to be opened in the books of the new firm, the adjustments being recorded through capital accounts of the partners.*

(b) *Building, machinery and vehicles were taken over at ₹ 50,000, ₹ 90,000 and ₹ 1,00,000 respectively.*

(c) *Provision for doubtful debts has to be carried forward at ₹ 4,000 in respect of debtors of S & Co. and ₹ 5,000 in respect of debtors of T & Co.*

You are required to:

(i) *Compute the adjustments necessary for goodwill.*

(ii) *Pass the journal entries in the books of BST & Co. assuming that excess/deficit capital (taking T's Capital as base) with reference to share in profits are to be transferred to current accounts.*

Solution

(i) Adjustment for raising & writing off of goodwill:

	Raised in old profit sharing ratio				Written off in new ratio		Difference	
	S & Co.	T & Co.	Total					
	₹	₹	₹		₹		₹	
B	45,000	-	45,000	Cr.	55,000	Dr.	10,000	Dr.

S	15,000	33,333	48,333	Cr.	36,666	Dr.	11,667	Cr.
T	–	16,667	16,667	Cr.	18,334	Dr.	1,667	Dr.
	60,000	50,000	1,10,000		1,10,000			

Books of BST & Co.

Journal Entries

2012			*Dr.* ₹	*Cr.* ₹
Oct. 31	Cash Account	Dr.	10,000	
	Bank Account	Dr.	15,000	
	T & Co.	Dr.	50,000	
	Sundry Debtors	Dr.	80,000	
	Stock Account	Dr.	60,000	
	Furniture Account	Dr.	10,000	
	Machinery Account	Dr.	90,000	
	Building Account	Dr.	50,000	
	To Provision for Doubtful debts			4,000
	To X & Co.			40,000
	To Sundry Creditors			60,000
	To B's Capital Account			1,65,750
	To S's capital Account			95,250
	(Sundry assets and liabilities of M/s S & Co. taken over at the values stated as per agreement dated.....)			
	Cash Account	Dr.	5,000	
	Bank Account	Dr.	20,000	
	X & Co. Account	Dr.	30,000	
	Sundry Debtors A/c	Dr.	1,00,000	
	Stock Account	Dr.	70,000	
	Furniture Account	Dr.	3,000	
	Vehicles Account	Dr.	1,00,000	
	To Provision for Doubtful Debts			5,000
	To S & Co.			50,000
	To Sundry Creditors			58,000
	To S's Capital Account			1,43,333
	To T's Capital Account			71,667
	(Sundry assets and liabilities of M/s T & Co. taken over at the values stated as per agreement dated...)			

	B's Capital Account Dr.		10,000	
	T's Capital Account Dr.		1,667	
	To S's Capital Account			11,667
	(Adjustment in capital accounts consequent on raising goodwill of S & Co. for ₹ 60,000, T & Co. for ₹ 50,000 and writing off the same in the new ratio between B,S,T as per agreement)			
	S & Co.		50,000	
	To T Co.			50,000
	(Mutual indebtedness of S & Co. and T & Co., cancelled on taking over of the two firms)			
	B's Current Account Dr.		54,250	
	To B's Capital Account			54,250
	(Amount credited to B's Capital to bring capital in profit-sharing ratio)			
	S's Capital Account Dr.		1,10,250	
	To S's Current Account			1,10,250
	(Excess amount in S's Capital Account transferred to S's current account to reduce the balance in capital accounts in accordance with the profit sharing ratio)			

Working Notes :

(i) Balance of Capital Accounts on transfer of business to M/s BST & Co.

(a) S & Co.		*B's Capital*	*S's Capital*
	₹	₹	₹
As per Balance Sheet		1,20,000	80,000
Credit for Reserve		18,750	6,250
Profit on Revaluation	40,000		
Less : Provision for doubtful debts	(4,000)	27,000	9,000
		1,65,750	95,250
(b) T & Co.		*S's Capital*	*T's Capital*
	₹	₹	₹
As per Balance Sheet		1,00,000	50,000
Credit for Reserve		33,333	16,667
Profit on Revaluation	20,000		
Less : Provision for doubtful debts	(5,000)	10,000	5,000
		1,43,333	71,667

(ii) Capital in the new firm

	B ₹	S ₹	T ₹
Balance as taken over	1,65,750	95,250	
	-	1,43,333	71,667
	1,65,750	2,38,583	71,667
Adjustment for Goodwill	–10,000	+11,667	–1,667
	1,55,750	2,50,250	70,000
Total capital, ₹ 4,20,000* in the new ratio of 3:2:1, taking T's Capital as the basis	2,10,000	1,40,000	70,000
Transfer to Current Account	54,250 (Dr.)	1,10,250 (Cr.)	—

*T's Capital is ₹ 70,000 and it is 1/6 of total. The total therefore is ₹ 4,20,000.

Illustration 2

On 31st March 2012, Sri Raman acquires on payment of ₹ 80,000 the business of M/s Gupta and Singh taking over at book value the following assets and liabilities :

	₹
Debtors	*35,000*
Furniture	*3,000*
Stock	*46,000*
Creditors	*10,000*

There was no change between 1st January, 2012 and 31st March, 2012 in the book value of the assets and liabilities not taken over.

The same set of books has been continued after the acquisition and no entries of the acquisition have been passed except for the payment of ₹ 80,000 made by Sri Raman.

From the following balance sheet and trial balance prepare Business Purchase Account, Profit and Loss Account for the year ended 31st December, 2012 and Balance Sheet at that date.

Balance Sheet as at December, 2011

Liabilities		*₹*	*Assets*	*₹*
Capital Accounts			*Furniture*	*3,000*
Sri Gupta	*30,000*		*Investments*	*5,000*
Sri Singh	*20,000*	*50,000*	*Insurance Policy*	*2,000*
Bank Loan		*18,000*	*Stock*	*40,000*
Creditors		*12,000*	*Debtors*	*30,000*
		80,000		*80,000*

On 31st December 2012 the trial balance is:

	₹	₹
Stock	*40,000*	
Furniture	*3,000*	
Investment	*5,000*	
Insurance Policy	*2,000*	
Business Purchase Account	*80,000*	
Bank Loan		*18,000*
Capital :		
Gupta		*30,000*
Singh		*20,000*
Raman		*30,000*
Bank	*3,000*	
Debtors	*48,000*	
Creditors		*15,000*
Purchases	*3,20,000*	
Expenses	*12,000*	
Sales		*4,00,000*
	5,13,000	*5,13,000*
Closing Stock ₹ 50,000		

Solution

Business Purchase Account

2012	₹	2012	₹
Dec. 31			
To Balance b/d	80,000	By Bank Loan	18,000
To Investments	5,000	By Gupta's Capital A/c	30,000
To Insurance Policy	2,000	By Singh's Capital A/c	20,000
		By Goodwill	6,000
		By Profit & Loss A/c	13,000
		(Balancing figure, profit upto 31st March, 2012)	
	87,000		87,000

Profit & Loss Account of Raman for the year ended 31st December, 2012

	₹		₹
To Opening Stock	40,000	By Sales	4,00,000
To Purchases	3,20,000	By Closing Stock	50,000
To Expenses	12,000		
To Business Purchase			
(Profit upto 31st March)	13,000		
To Net Profit			
Raman's Capital A/c	65,000		
	4,50,000		4,50,000

Balance Sheet of Raman as on 31st December, 2012

Liabilities		₹	*Assets*	₹
Raman's Capital A/c	30,000		Goodwill	6,000
Add : Profit	65,000	95,000	Furniture	3,000
Sundry Creditors		15,000	Stock in trade	50,000
			Sundry Debtors	48,000
			Cash at Bank	3,000
		1,10,000		1,10,000

Working Notes :

(1) *Goodwill*

	₹
Value of Assets taken over	
Stock	46,000
Debtors	35,000
Furniture	3,000
	84,000
Less : Creditors	(10,000)
Net assets	74,000
Goodwill (Balancing figure)	6,000
Purchase Consideration	80,000

(2) *Increase in net assets upto 31st March 2012* :

	as on 1st January ₹	*as on 31st March* ₹
Debtors	30,000	35,000
Stock	40,000	46,000
Furniture	3,000	3,000
	73,000	84,000
Less : Creditors	(12,000)	(10,000)
	61,000	74,000
Profit, equal to net increase	13,000	–
	74,000	74,000

Illustration 3

Firm X & Co. consists of partners A and B sharing Profits and Losses in the ratio of 3 : 2. The firm Y & Co. consists of partners B and C sharing Profits and Losses in the ratio of 5 : 3.

On 31st March, 2012 it was decided to amalgamate both the firms and form a new firm XY & Co., wherein A, B and C would be partners sharing Profits and Losses in the ratio of 4:5:1.

Balance Sheet as at 31.3.2012

Liabilities	*X & Co.*	*Y & Co.*	*Assets*	*X & Co.*	*Y & Co.*
	₹	₹		₹	₹
Capital:			*Cash in hand/bank*	*40,000*	*30,000*
A	*1,50,000*	---	*Debtors*	*60,000*	*80,000*
B	*1,00,000*	*75,000*	*Stock*	*50,000*	*20,000*
C	---	*50,000*	*Vehicles*	---	*90,000*
Reserve	*50,000*	*40,000*	*Machinery*	*1,20,000*	---
Creditors	*1,20,000*	*55,000*	*Building*	*1,50,000*	---
	4,20,000	*2,20,000*		*4,20,000*	*2,20,000*

The following were the terms of amalgamation:

(i) *Goodwill of X & Co., was valued at ₹ 75,000. Goodwill of Y & Co. was valued at ₹ 40,000. Goodwill account not to be opened in the books of the new firm but adjusted through the Capital accounts of the partners.*

(ii) *Building, Machinery and Vehicles are to be taken over at ₹ 2,00,000, ₹ 1,00,000 and ₹ 74,000 respectively.*

(iii) Provision for doubtful debts at ₹ 5,000 in respect of X & Co. and ₹ 4,000 in respect of Y & Co. are to be provided.

You are required to:

(i) Show, how the Goodwill value is adjusted amongst the partners.

(ii) Prepare the Balance Sheet of XY & Co. as at 31.3.2012 by keeping partners capital in their profit sharing ratio by taking capital of 'B' as the basis. The excess or deficiency to be kept in the respective Partners' Current accounts.

Solution

(i) Adjustment for raising and writing off of goodwill

	Raised in old profit sharing ratio		*Total*	Written off in new ratio	Difference
	X & Co.	Y & Co.			
	3:2 ₹	5:3 ₹	₹	₹	₹
A	45,000	---	45,000 Cr.	46,000 Dr.	1,000 Dr.
B	30,000	25,000	55,000 Cr.	57,500 Dr.	2,500 Dr.
C	---	15,000	15,000 Cr.	11,500 Dr.	3,500 Cr.
	75,000	40,000	1,15,000	1,15,000	Nil

(ii) Balance Sheet of X Y & Co.(New firm) as on 31.3.2012

Liabilities	₹	**Assets**	₹
Capital Accounts:		Vehicle	74,000
A	1,72,000	Machinery	1,00,000
B	2,15,000	Building	2,00,000
C	43,000	Stock	70,000
Current Accounts:		Debtors	1,31,000
A	22,000	Cash & Bank	70,000
C	18,000		
Creditors	1,75,000		
	6,45,000		6,45,000

Working Notes:

1. Balance of Capital Accounts at the time of amalgamation of firms

	A's Capital ₹	*B's Capital* ₹
X & Co. Profit and loss sharing ratio 3:2		
Balance as per Balance Sheet	1,50,000	1,00,000

Add: Reserves	30,000	20,000
Revaluation profit (Building)	30,000	20,000
Less: Revaluation loss (Machinery)	(12,000)	(8,000)
Provision for doubtful debt	(3,000)	(2,000)
	1,95,000	1,30,000
	B's Capital	*C's Capital*
Y & Co. Profit and loss sharing ratio 5:3	₹	₹
Balance as per Balance sheet	75,000	50,000
Add: Reserves	25,000	15,000
Less: Revaluation (vehicle)	(10,000)	(6,000)
Provision for doubtful debts	(2,500)	(1,500)
	87,500	57,500

2. Balance of Capital Accounts in the balance sheet of the new firm as on 31.3.2012

	A ₹	*B* ₹	*C* ₹
Balance b/d: X & Co.	1,95,000	1,30,000	--
Y & Co.	--	87,500	57,500
	1,95,000	2,17,500	57,500
Adjustment for goodwill	(1,000)	(2,500)	3,500
	1,94,000	2,15,000	61,000
Total capital ₹ 4,30,000 (B's capital* i.e. ₹ 2,15,000 x 2) to be contributed in 4:5:1 ratio.	1,72,000	2,15,000	43,000
Transfer to Current Account	22,000	---	18,000

2.2 Conversion of Partnership Firm into a Company

At times partnerships also are reconstructed like joint stock companies, with the help of creditors if they are satisfied that if by taking of further risk or forgoing a part of the debt, the chances of recovery of their loan and capital would improve.

It usually entails preparation of Reconstruction Account for determining the past losses which belong to old partners and writing them off to the debit of their capital accounts. If a creditor agrees to join as a partner the whole or only a part of the account standing to the credit of his

* B's Capital ₹ 21,500 being one-half of the total capital of the firm.

loan account is transferred to his capital account. For the further development of the business, usually some fresh capital/loan is required. The amount of loan is placed to the credit of the party contributing the same on such terms and conditions as may have been agreed upon.

When the partnership firm is converted into a company, then the financial statements of the new company will be prepared according to Schedule III to the Companies Act, 2013. The general instructions for preparation of Balance sheet and the Statement of Profit and Loss of the company are given in Schedule III to the Companies Act, 2013.

Illustration 4

The following is the Balance Sheet of Messers A and B as on 31st March 2011 :

Liabilities		*₹*	*Assets*	*₹*
A's Capital	*40,000*		*Land and Buildings*	*50,000*
B's Capital	*50,000*	*90,000*	*Stock*	*30,000*
A's Loan		*10,000*	*Debtors*	*20,000*
General Reserve		*10,000*	*Investment*	
Liabilities		*20,000*	*6% Debentures in X Ltd.*	*20,000*
			Cash	*10,000*
		1,30,000		*1,30,000*

It was agreed that Mr. C is to be admitted for a fifth share in the future profits from 1st April 2011. He is required to contribute cash towards goodwill and ₹ 10,000 towards capital.

The following further information is furnished :

(i) The partners A and B shared the profits in the ratio 3:2.

(ii) Mr. A was receiving a salary of ₹ 500 p.m. from the very inception of the firm in 1998 in addition to share of profit.

(iii) The future profit ratio between A, B and C will be 3:1:1. Mr. A will not get any salary after the admission of Mr. C.

(iv) (a) The goodwill of the firm shall be determined on the basis of 2 years' purchase of the average profits from business of the last 5 years. The particulars of the profits are as under :

			₹
Year ended	*31-3-07*	*Profit*	*20,000*
Year ended	*31-3-08*	*Loss*	*10,000*
Year ended	*31-3-09*	*Profit*	*20,000*
Year ended	*31-3-10*	*Profit*	*25,000*
Year ended	*31-3-11*	*Profit*	*30,000*

The above profits and losses are after charging the salary of Mr. A. The profit of the *year ended 31st March 2007 included an extraneous profit of ₹ 30,000 and the loss of the year ended 31st March 2008 was on account of loss by strike to the extent of ₹ 20,000.*

(b) It was agreed that the value of the goodwill of the firm shall appear in the books of the firm.

(v) The trading profit for the year ended 31st March, 2012 was ₹ 40,000 before depreciation.

(vi) The partners had drawn each ₹ 1,000 p.m. as drawings.

(vii) The value of the other assets and liabilities as on 31st March, 2012 were as under :

	₹
Building (before depreciation)	*60,000*
Stock	*40,000*
Debtors	*Nil*
Investment	*20,000*
Liabilities	*Nil*

(viii) Provide depreciation at 5% on land and buildings on the closing balance and interest at 6% on A's loan.

(ix) They applied for conversion of the firm into a Private Limited Company i.e. ABC Pvt. Ltd.. Certificate received on 1-4-2012. They decided to convert Capital A/cs of the partners into share capital in the ratio of 3 : 1 :1 on the basis of total Capital as on 31-3-2012. If necessary, partners have to subscribe to fresh capital or withdraw.

Prepare the Statement of Profit and Loss for the year ended 31st March, 2012 and the Balance Sheet of the company.

Solution

Messers A, B and C
Statement of Profit & Loss for the year ended on 31st March, 2012

	₹		₹
To Dep. Building	3,000	By Trading Profit	40,000
To Interest on A's loan	600	By Interest on Debentures	1,200
To Net Profit to :			
A's Capital A/c	22,560		
B's Capital A/c	7,520		
C's Capital A/c	7,520		
	41,200		41,200

Balance Sheet of the ABC Pvt Ltd. as on 1-4-2012

		Notes No.	₹
I	**Equity and Liabilities**		
	Shareholders funds		1,59,120
	Non-current liabilities		
	Long term borrowings	1	10,600
	Total		1,69,720
	Assets		
	Non-current assets		
	Fixed assets		
	Tangible assets	2	57,000
	Intangible assets	3	39,600
	Non-current investments		20,000
	Current assets		
	Inventories		40,000
	Cash and cash equivalents		13,120
	Total		1,69,720

Notes to Accounts

		₹
1.	Long term borrowings	
	Loan from A	10,600
2.	Tangible asset	
	Land and Building	57,000
3.	Intangible asset	
	Goodwill	39,600
4.	Other income	
	Interest on debentures	1,200
5.	Finance cost	
	Interest on A's loan	600

Working Notes:

1. **Calculation of goodwill:**

Year ended March, 31

	2007 ₹	2008 ₹	2009 ₹	2010 ₹	2011 ₹
Book Profits	20,000	(10,000)	20,000	25,000	30,000
Adjustment for extraneous profit 2007 and abnormal loss 2008	(30,000)	20,000	—	—	—

	(10,000)	10,000	20,000	25,000	30,000
Add Back: Remuneration of A	6,000	6,000	6,000	6,000	6,000
	(4,000)	16,000	26,000	31,000	36,000
Less : Debenture Interest being non-operating income*	(1,200)	(1,200)	(1,200)	(1,200)	(1,200)
	(5,200)	14,800	24,800	29,800	34,800
Total Profit from 2008 to 2011					1,04,200
Less : Loss for 2007					(5,200)
					99,000
Average Profit					19,800
Goodwill equal to 2 years' purchase					39,600
Contribution from C, equal to 1/5					7,920

2. **Partners' Capital Accounts**

	A ₹	*B* ₹	*C* ₹		*A* ₹	*B* ₹	*C* ₹
To Drawings	12,000	12,000	12,000	By Balance b/d	40,000	50,000	—
To Balance c/d	80,320	65,360	13,440	By General Reserve	6,000	4,000	—
				By Goodwill	23,760	15,840	—
				By Bank	—	—	17,920
				By Profit & Loss A/c	22,560	7,520	7,520
	92,320	77,360	25,440		92,320	77,360	25,440

3. **Balance Sheet as on 31st March, 2012**

Liabilities	₹	₹	*Assets*	₹	₹
A's Capital		80,320	Goodwill		39,600*
B's Capital		65,360	Land & Building	60,000	
C's Capital		13,440	*Less* : Dep.	(3,000)	57,000
A's Loan	10,000		Investments		20,000
Add : Int. due	600	10,600	Stock-in-trade		40,000
			Cash (Balancing figure)		13,120**
		1,69,720			1,69,720

4. Conversion into Company

		₹
Capital :	A	80,320
	B	65,360
	C	13,440
Share Capital		1,59,120
Distribution of share :	A (3/5)	95,472
	B (1/5)	31,824
	C (1/5)	31,824

A should subscribe shares of ₹ 15,152 (₹ 95,472 – ₹ 80,320) and C should subscribe shares of ₹ 18,384 (₹ 31,824 – ₹ 13,440) B withdraws ₹ 33,536 (₹ 65,360 – ₹ 31,824) subscribing to shares worth ₹ 31,824.

* It is shown in the books of the firm only to determine the closing capital of partners inclusive of goodwill before conversion.

** Also the closing cash balance can be derived as shown below :

	₹	₹
Trading profit (assume realised)		40,000
Add: Debenture Interest		1,200
Add: Decrease in Debtors Balance		20,000
		61,200
Less: Increase in stock	10,000	
Less: Decrease in Liabilities	20,000	(30,000)
Cash Profit		31,200
Add: Opening cash balance		10,000
Add: Cash brought in by C		17,920
		59,120
Less: Drawings	36,000	
Less: Additions to Building	10,000	(46,000)
		13,120

Illustration 5

Hari, Lal and Jay have been in partnership for a number of years, sharing profits/losses in the ratio of 2:2:1 as wholesale stationers trading under the name 'Hari Brothers'. They decide to convert their partnership into a limited company (with effect from 1st January, 2013) to be known as Hari Ltd.

Immediately prior to this conversion the balance sheet of partnership as at 31st December 2012 was as follows:

Balance Sheet
As on 31st December 2012

Liabilities	₹	₹	Assets	₹
Capital accounts			Fixed assets	
Hari	70,000		(at written down value)	
Lal	30,000		Land & Buildings	50,000
Jay	20,000	1,20,000	Plant & Machinery	30,000
Current accounts			Motor vehicles	20,000
Hari	7,000		Current Assets:	
Lal	5,000		Inventories	60,000
Jay	3,000	15,000	Debtors	25,000
Current liabilities			Axis Bank account	5,000
Creditors	25,000			
Dena Bank account	20,000	45,000		
Long-term liabilities				
Loan-Hari	3,000			
Loan-Gopi Ltd.	7,000	10,000		
		1,90,000		1,90,000

The terms of conversion are that Hari Ltd. is to take over the assets and liabilities of Hari Brothers as follows:

	Valuation for take-over ₹
Land and Building	96,000
Plant and Machinery	28,000
Motor vehicles	15,000
Inventories	60,000
Debtors	24,000
Creditors	25,000
Goodwill	10,000

The closing balance in Axis Bank account is to be transferred to Dena Bank account before all the other dissolution entries are effected in the partnership ledgers.

Lal took over one of the motor vehicles at an agreed amount of ₹ 2,000. All other liabilities were paid from the Dena Bank account.

The purchase consideration is discharged by an issue at par of ₹ 60,000 10% Debentures (fully paid) to the partners in their capital account proportions as shown in the above balance sheet plus equity shares in Hari Ltd. of ₹ 1 each (fully paid to make up the balance due to each partner).

You are required to

(i) prepare (a) Realisation Account (b) Partners' Capital Accounts (c) Bank account of Axis Bank and Dena Bank in the books of Hari Brothers;

(ii) 'Business purchase account' and 'Hari Brothers' account in Hari Ltd.'s books.

Solution

(i) (a) In the books of Hari Brothers

Realisation Account

		₹	₹			₹
To	Land and buildings		50,000	By	Creditors	25,000
To	Plant and machinery		30,000	By	Lal's capital A/c	2,000
To	Motor vehicles		20,000	By	Dena Bank A/c	25,000
To	Inventories		60,000	By	Hari Ltd.	1,83,000
To	Debtors		25,000			
To	Partners' capital accounts					
	Hari (2/5)	20,000				
	Lal (2/5)	20,000				
	Jay (1/5)	10,000	50,000			
			2,35,000			2,35,000

(b) Partners' Capital Accounts

	Particulars	Hari ₹	Lal ₹	Jay ₹		Particulars	Hari ₹	Lal ₹	Jay ₹
To	Realisation A/c(motor vehicle takeover)		2,000		By	Balance b/d	70,000	30,000	20,000
To	10% Debentures*	35,000	15,000	10,000	By	Current A/c	7,000	5,000	3,000
To	Equity shares	62,000	38,000	23,000	By	Realisation A/c Profit	20,000	20,000	10,000
		97,000	55,000	33,000			97,000	55,000	33,000

*** Debentures have been issued in proportion of capital account balances i.e. in ratio of 7:3:2.**

(c) **Bank Account**

	Particulars	Axis Bank	Dena Bank		Particulars	Axis Bank	Dena Bank
		₹	₹			₹	₹
To	Balance b/d	5,000	-	By	Balance b/d	-	20,000
To	Axis Bank	-	5,000	By	Loan (Gopi Ltd.)	-	7,000
To	Realisation A/c	-	25,000	By	Loan-Hari	-	3,000
				By	Dena Bank	5,000	
		5,000	30,000			5,000	30,000

(ii) **In the books of Hari Ltd.**

Business Purchase Account

		₹			₹
To	Creditors	25,000	By	Land and buildings	96,000
To	Dena Bank (overdraft)	25,000	By	Plant and Machinery	28,000
To	Hari Brothers	1,83,000	By	Motor Vehicles	15,000
			By	Inventories	60,000
			By	Debtors	24,000
			By	Goodwill	10,000
		2,33,000			2,33,000

Hari Brothers Account

		₹		₹
To	10% Debentures A/c	60,000	By Business purchase	1,83,000
To	Equity share capital A/c	1,23,000		
		1,83,000		1,83,000

Partnership-Sale to a Company

Illustration 6

A and B were carrying on business sharing profits and losses equally. The firm's Balance Sheet as at 31.12.2011 was:

Liabilities	₹	*Assets*	₹
Sundry Creditors	*60,000*	*Stock*	*60,000*
Bank overdraft	*35,000*	*Machinery*	*1,50,000*
Capital A/cs:		*Debtors*	*70,000*

A	*1,40,000*		*Joint Life Policy*		*9,000*
B	*1,30,000*	*2,70,000*	*Leasehold Premises*		*34,000*
			Profit & Loss A/c		*26,000*
			Drawings Accounts:		
			A	*10,000*	
			B	*6,000*	*16,000*
		3,65,000			*3,65,000*

The business was carried on till 30.6.2012. The partners withdrew in equal amounts half the amount of profits made during the period of six months after charging depreciation at 10% p.a. on machinery and after writing off 5% on leasehold premises. In the half year, sundry creditors were reduced by ₹ 10,000 and bank overdraft by ₹ 15,000.

On 30.6.2012, stock was valued at ₹ 75,000 and Debtors at ₹ 60,000; the Joint Life Policy had been surrendered for ₹ 9,000 before 30.6.2012 and other items remained the same as at 31.12.2011.

On 30.6.2012, the firm sold the business to a Limited Company. The value of goodwill was fixed at ₹ 1,00,000 and the rest of the assets were valued on the basis of the Balance Sheet as at 30.6.2012. The company paid the purchase consideration in Equity Shares of ₹ 10 each.

You are required to prepare: (a) Balance Sheet of the firm as at 30.6.2012; (b) The Realisation Account; (c) Partners' Capital Accounts showing the final settlement between them.

Solution

(a) **Balance Sheet as on 30.6.2012**

Liabilities	₹	₹	*Assets*	₹	₹
Capital Accounts:			Machinery	1,50,000	
A's balance as on 1.1.2012	1,17,000		*Less*: Depreciation @ 10% p.a.	(7,500)	1,42,500
Add: Profit for 6 months	11,800		Leasehold premises	34,000	
	1,28,800		*Less*: Written-off @ 5%	(1,700)	32,300
Less: Drawings for 6 months	(5,900)	1,22,900	Stock		75,000
B's balance as on 1.1.2012	1,11,000		Sundry Debtors		60,000
Add: Profit for 6 months	11,800				
	1,22,800				
Less: Drawings for 6					

months	(5,900)	1,16,900		
Sundry Creditors		50,000		
Bank overdraft		20,000		
		3,09,800		3,09,800

(b) **Realisation Account**

	Particulars	₹		Particulars	₹
To	Machinery A/c	1,42,500	By	Sundry Creditors A/c	50,000
To	Leasehold Premises A/c	32,300	By	Bank Overdraft A/c	20,000
To	Stock A/c	75,000	By	Limited Company A/c (W.N.2)	3,39,800
To	Sundry Debtors A/c	60,000			
To	A's Capital A/c	50,000			
To	B's Capital A/c	50,000			
		4,09,800			4,09,800

(c) **Partners' Capital Accounts**

Date		Particulars	A	B	Date		Particulars	A	B
			₹	₹				₹	₹
1.1.12	To	Profit & Loss A/c	13,000	13,000	1.1.12	By	Balance b/d	1,40,000	1,30,000
	To	Drawings A/c	10,000	6,000					
29.6.12	To	Balance c/d	1,17,000	1,11,000					
			1,40,000	1,30,000				1,40,000	1,30,000
30.6.12	To	Drawings A/c	5,900	5,900	30.6.12	By	Balance b/d	1,17,000	1,11,000
	To	Shares in Limited Company A/c	1,72,900	1,66,900	30.6.12	By	Profit & Loss Appropriation A/c	11,800	11,800
						By	Realisation A/c	50,000	50,000
			1,78,800	1,72,800				1,78,800	1,72,800

Working Notes:

(1) Ascertainment of profit for the 6 months ended 30th June, 2012

Closing Assets:	₹	₹
Stock		75,000
Sundry Debtors		60,000
Machinery less depreciation		1,42,500

Leasehold premises less written off		32,300
		3,09,800
Less: Closing liabilities:		
Sundry Creditors	50,000	
Bank overdraft	20,000	(70,000)
Closing Net Assets		2,39,800
Less: Opening combined capital:		
A – ₹ (1,40,000 – 13,000 – 10,000)	1,17,000	
B – ₹ (1,30,000 – 13,000 – 6,000)	1,11,000	(2,28,000)
Profit before adjustment of drawings		11,800
Add: Combined drawings during the 6 months (equal to profit)		11,800
Profit for 6 months		23,600

(2) Ascertainment of purchase consideration:

Closing net assets (as above) ₹ 2,39,800 + Goodwill ₹ 1,00,000 = ₹ 3,39,800.

Illustration 7

A, B and C were in partnership sharing profits and losses 3:2:1. There was no provision in the agreement for interest on capitals or drawings.

A died on 31.12.2011 and on that date, the partners' balance were as under:

Capital Account : A – ₹ 60,000; B- ₹ 40,000; C- ₹ 20,000

Current Account: A – ₹ 29,000; B – ₹ 20,000; C – ₹ 5,000 (Dr.).

By the partnership agreement, the sum due to A's estate was required to be paid within a period of 3 years, and minimum instalment of ₹ 20,000 each were to be paid, the first such instalment falling due immediately after death and the subsequent instalments at half-yearly intervals. Interest @ 5% p.a. was to be credited half-yearly.

In ascertaining his share, goodwill (not recorded in the books) was to be valued at ₹ 60,000 and the assets, excluding the Joint Endowment Policy (mentioned below), were valued at ₹ 36,000 in excess of the book values.

No Goodwill Account was raised and no alteration was made to the book values of fixed assets. The Joint Assurance Policy shown in the books at ₹ 20,000 matured on 1.1.2011, realising ₹ 26,000; payments of ₹ 20,000 each were made to A's Executors on 1.1.2011, 30.6.2011 and 31.12.2011. B and C continued trading on the same terms as previously and the net profit for the year to 31.12.2011 (before charging the interest due to A's estate) amounted to ₹ 32,000. During that period, the partners drawings were: B- ₹ 15,000; and C- ₹ 8,000.

On 1.1.2012, the partnership was dissolved and an offer to purchase the business as a going concern for ₹ 1,40,000 was accepted on that day. A cheque for that sum was received on 30.6.2012.

The balance due to A's estate, including interest, was paid on 30.6.2012 and on that day, B and C received the sums due to them.

You are required to write-up the Partners' Capital and Current Accounts from 1.1.2011 to 30.6.2012. Show also the account of the executors of A.

Solution

Partners' Current Accounts

Particulars	A	B	C	Particulars	A	B	C
1.1.2011	₹	₹	₹	1.1.2011	₹	₹	₹
To Balance b/d	---	----	5,000	By Balance b/d	29,000	20,000	--
To A's Current A/c – goodwill	-	20,000	10,000	By B's Current A/c – goodwill	20,000	--	--
To A's Current A/c – Revaluation Profit	-	12,000	6,000	By C's Current A/c – goodwill	10,000	-	-
To A's Capital A/c – transfer	80,000	-	-	By B's Current A/c – Revaluation profit	12,000	-	-
				By C's Current A/c – Revaluation profit	6,000		
				By Joint Life Policy A/c (₹ 26,000 – ₹ 20,000)	3,000	2,000	1,000
				By Balance c/d		10,000	20,000
	80,000	32,000	21,000		80,000	32,000	21,000
1.1.2011				31.12.2011			
To Balance b/d		10,000	20,000	By Profit & Loss Appropriation A/c		17,617	8,808
31.12.2011				By Balance c/d		7,383	19,192
To Drawings A/c		15,000	8,000				
		25,000	28,000			25,000	28,000
1.1.2012				30.6.2012			
To Balance b/d		7,383	19,192	By Realisation A/c - profit		12,573	6,287
To B's Capital A/c – transfer		5,190	---	By C's Capital A/c - transfer		---	12,905
		12,573	19,192			12,573	19,192

Partners' Capital Accounts

Particulars	A	B	C	Particulars	A	B	C
1.1.2011	₹	₹	₹	1.1.2011	₹	₹	₹
To A's Executors A/c	1,40,000	----	---	By Balance b/d	60,000	40,000	20,000
To Balance c/d	---	40,000	20,000	By A's Current A/c	80,000	--	--
	1,40,000	40,000	20,000		1,40,000	40,000	20,000
31.12.2011				1.1.2011			
To Balance c/d		40,000	20,000	By Balance b/d		40,000	20,000
		40,000	20,000			40,000	20,000
30.6.2012				1.1.2012			
To C's Current A/c – transfer		---	12,905	By Balance b/d		40,000	20,000
To Bank A/c		45,190	7,095	30.6.2012			
				By B's Current A/c – transfer		5,190	---
		45,190	20,000			45,190	20,000

A's Executors Account

Date	Particulars	₹	Date	Particulars	₹
1.1.2011	To Bank A/c	20,000	1.1.2011	To A's Capital A/c	1,40,000
1.1.2011	To Balance c/d	1,20,000			
		1,40,000			1,40,000
30.6.2011	To Bank A/c	20,000	1.1.2011	By Balance b/d	1,20,000
30.6.2011	To Balance c/d	1,03,000	30.6.2011	By Interest A/c	3,000
		1,23,000			1,23,000
31.12.2011	To Bank A/c	20,000	1.7.2011	By Balance b/d	1,03,000
31.12.2011	To Balance c/d	85,575	31.12.2011	By Interest A/c	2,575
		1,05,575			1,05,575
30.6.2012	To Bank A/c	87,715	1.1.2012	By Balance b/d	85,575
			30.6.2012	By Interest A/c	2,140
		87,715			87,715

Working Notes:

(1) Adjustment in regard to Goodwill

Partners		A	B	C
Share of goodwill before death	(₹)	30,000	20,000	10,000
Share of goodwill after death	(₹)	-	40,000	20,000
Gain (+)/Sacrifice (-)	(₹)	(30,000)	20,000	10,000
		Cr.	Dr.	Dr.

(2) Adjustment in regard to revaluation of assets

Partners		A	B	C
Share of profit on revaluation credited to all the partners	(₹)	18,000	12,000	6,000
Debited to the continuing partners	(₹)	-	24,000	12,000
	(₹)	(18,000)	12,000	6,000
		Cr.	Dr.	Dr.

(3) Ascertainment of Profit for the year ended 31.12.2011

	₹	₹
Profit before charging interest on balance due to A's executors		32,000
Less: Interest payable to A's executors:		
from 1.1.2011 to 30.6.2011	3,000	
From 1.7.2011 to 31.12.2011	2,575	(5,575)
Balance of profit to be shared by B and C		26,425

(4) Ascertainment of Profit for the year ended 31.12.2011

Liabilities	₹	*Assets*	₹
Capital Account – B	40,000	Sundry Assets (balancing figure)	1,19,000
Capital Account – C	20,000	Partners' Current A/cs –B	7,383
A's Executors A/c	85,575	Partners' Current A/cs- C	19,192
	1,45,575		1,45,575

(5) Realisation Account

	₹		₹
To Sundry Assets A/c	1,19,000	By Bank A/c (purchase consideration)	1,40,000
To Interest A/c – A's Executors	2,140		
To Partners' Capital A/cs – B	12,573		
To Partners' Capital A/cs – C	6,287		
	1,40,000		1,40,000

2.2.1 Apportionment of shares amongst the partners

Sometime an examination problem may require the students to suggest equitable basis for division of shares between the vendors, when they are partners, so as to preserve the rights as previously existed between them, that is, to maintain the same profit-sharing ratio and to preserve the priority in regard to repayment of capital.

Suppose A, B and C share profits and losses in the ratio 3 : 2 : 1 after allowing interest on capital @ 9% p.a. Their capitals on 31st December, 2011 were: A ₹ 50,000, B ₹ 30,000 and C ₹ 20,000. On 1st January, 2012 the business was converted into a limited company and was valued at ₹ 1,30,000. A scheme of capitalisation, whereby the mutual interest of partners may remain intact as far as possible is suggested below:

The total capital being ₹ 1,00,000 and the value placed on the business being ₹ 1,30,000 there is goodwill of ₹ 30,000 to be shared by the partners in the ratio of 3:2:1 or A ₹ 15,000, B ₹ 10,000 and C ₹ 5,000. The capital will now be: A ₹ 65,000, B ₹ 40,000 and C ₹ 25,000.

Taking B's capital as the basis, A's capital should be ₹ 60,000, i.e. 40,000 × 3/2 and C's capital should be ₹ 20,000. Both A and C have ₹ 5,000 excess. Since interest on capital is meant to compensate those whose capital is in excess of proportionate limits and since in the case of partners it is an appropriation of profit, it will be proper to give 9% preference shares to A & C for ₹ 5,000 each and the remaining amount of ₹ 1,20,000 can be in the form of equity shares to be divided among A, B and C in the ratio of 3 : 2 : 1. They will then share the company's profit in the ratio of 3 : 2 : 1 after allowing preference dividend.

Illustration 8

Prabhu & Co. is a partnership firm consisting of Mr. Prabhu, Mr. Bhola and Mr. Shiv who share profits and losses in the ratio of 2:2:1 and Bhagwan Ltd. is a company doing similar business.

Following is the Balance sheet of the firm and that of the company as at 31.3.2012:

Liabilities	*Prabhu & Co.*	*Bhagwan Ltd.*		*Prabhu & Co.*	*Bhagwan Ltd.*
	₹	₹		₹	₹
Equity share Capital:			*Plant & machinery*	*2,50,000*	*8,00,000*
Equity shares of ₹ 10 each		*10,00,000*	*Furniture & fixture*	*25,000*	*1,12,500*
			Stock in trade	*1,00,000*	*4,25,000*
Partners' capital:			*Sundry debtors*	*1,00,000*	*4,12,500*
Prabhu	*1,00,000*		*Cash at bank*	*5,000*	*2,00,000*
Bhola	*1,50,000*		*Cash in hand*	*20,000*	*50,000*
Shiv	*50,000*				
General reserve	*50,000*	*3,50,000*			
Sundry creditors	*1,50,000*	*6,50,000*			
	5,00,000	*20,00,000*		*5,00,000*	*20,00,000*

It was decided that the firm Prabhu & Co. be dissolved and all the assets (except cash in hand and cash at bank) and all the liabilities of the firm be taken over by Bhagwan Ltd. by issuing 25,000 shares of ₹ 10 each at a premium of ₹ 2 per share.

Partners of Prabhu & Co. agreed to divide the shares issued by Bhagwan Ltd. in the profit sharing ratio and bring necessary cash for settlement of their capital.

The creditors of Prabhu & Co. includes ₹ 50,000 payable to Bhagwan Ltd. An unrecorded liability of ₹ 12,500 of Prabhu & Co. must also be taken over by Bhagwan Ltd.

Prepare:

(i) Realisation account, Partners' capital accounts and Cash in hand/Bank account in the books of Prabhu & Co.

(ii) Pass journal entries in the books of Bhagwan Ltd. for acquisition of Prabhu & Co.

Solution

(i) In the books of Prabhu & Co.

Realisation Account

	₹		₹
To Plant & Machinery	2,50,000	By Sundry Creditors	1,50,000
To Furniture & Fixture	25,000	By Bhagwan Ltd. (Refer W.N.)	3,00,000
To Stock in trade	1,00,000	By Partners' Capital Accounts (loss):	
To Sundry Debtors	1,00,000	Prabhu's Capital A/c	10,000
		Bhola's Capital A/c	10,000
		Shiv's Capital A/c	5,000
	4,75,000		4,75,000

Partners' Capital Accounts

	Prabhu	*Bhola*	*Shiv*		*Prabhu*	*Bhola*	*Shiv*
	₹	₹	₹		₹	₹	₹
To Realisation A/c	10,000	10,000	5,000	By Balance b/d	1,00,000	1,50,000	50,000
To Shares in Bhagwan Ltd.	1,20,000	1,20,000	60,000	By General Reserve	20,000	20,000	10,000
To Cash	-	40,000	-	By Cash	10,000	-	5,000
	1,30,000	1,70,000	65,000		1,30,000	1,70,000	65,000

Cash and Bank Account

	₹	₹		₹	₹
To Balance b/d	20,000	5,000	By Cash A/c (Contra)*		5,000
To Bank A/c (Contra)*	5,000		By Bhola	40,000	
To Prabhu	10,000				

* It is assumed that cash at bank has been withdrawn to pay to Partner Bhola.

To Shiv	5,000	____		____	____
	40,000	5,000		40,000	5,000

(ii)

In the Books of Bhagwan Ltd.
Journal Entries

			Dr. (₹)	*Cr. (₹)*
1.	Business Purchase Account	Dr.	3,00,000	
	To Liquidators of Prabhu & Co.			3,00,000
	(Being business of Prabhu & Co. purchased and payment due)			
2.	Plant and Machinery A/c	Dr.	2,50,000	
	Furniture and Fixture A/c	Dr.	25,000	
	Stock in Trade A/c	Dr.	1,00,000	
	Sundry Debtors A/c	Dr.	1,00,000	
	To Sundry Creditors			1,50,000
	To Unsecured Liability			12,500
	To Business Purchase Account			3,00,000
	To Capital Reserve (B.F.)			12,500
	(Being take over of all assets and liabilities)			
3.	Liquidators of Prabhu & Co.	Dr.	3,00,000	
	To Equity Share Capital Account			2,50,000
	To Securities Premium Account			50,000
	(Being purchase consideration discharged in the form of shares of ₹ 10 each issued at a premium of ₹ 2 each)			
4.	Sundry Creditors Account	Dr.	50,000	
	To Sundry Debtors Account			50,000
	(Being mutual owing eliminated)			

Working Note:

Computation of purchase consideration:

25,000 Equity shares of ₹ 12 each = ₹ 3,00,000

Equity shares to be given to partners :

Prabhu	=	10,000 Shares @ ₹ 12 = ₹ 1,20,000
Bhola	=	10,000 shares @ ₹ 12 = ₹ 1,20,000
Shiv	=	5,000 shares @ ₹ 12 = ₹ 60,000

Illustration 9

P and Q were carrying on business sharing profits and losses equally. The firm's Balance Sheet as at 31.12.2013 was:

Liabilities		₹	Assets		₹
Capital Accounts:			Plant		1,60,000
P	1,50,000		Building		48,000
Q	1,30,000	2,80,000	Debtors		75,000
Sundry Creditors		80,000	Stock		70,000
Bank Overdraft		45,000	Joint Life Policy		6,000
			Profit & Loss A/c		30,000
			Drawings Account:		
			P	9,000	
			Q	7,000	16,000
		4,05,000			4,05,000

The operations of the business were carried on till 30.06.2014. P and Q both withdrew in equal amount half the amount of profit made during the current period of six months after charging depreciation at 10% per annum on plant and after writing off 5% on building.

During the current period of six months, creditors were reduced by ₹ 20,000 and bank overdraft by ₹ 5,000.

The joint life policy was surrendered for ₹ 6,000 before 30th June 2014. Stock was valued at ₹ 84,000 and debtors at ₹ 68,000 on 30th June 2014. The other items remained the same as at 31.12.2013.

On 30.06.2014, the firm sold its business to PQ Ltd. The value of goodwill was estimated at ₹ 1,30,000 and the remaining assets were valued on the basis of the balance sheet as on 30.06.2014.

PQ Ltd. paid the purchase consideration in equity shares of ₹ 10 each.

You are required to prepare:

(a) Balance sheet of the firm as at 30.06.2014,

(b) Realisation account,

(c) Partners' Capital Accounts showing the final settlement between them. (16 Marks)

Answer

(a) Balance sheet of the firm as at 30.06.2014

Liabilities	₹	*Assets*		₹
Capital Accounts:		Plant :		
P's Capital	1,33,800	Opening Balance	1,60,000	
Q's Capital	1,15,800	*Less*: Depreciation @ 10%	8,000	1,52,000
Creditors	60,000	Building:		
Bank Overdraft	40,000	Opening Balance	48,000	
		Less: Written-off @ 5%	2,400	45,600
		Debtors		68,000
		Stock		84,000
Total	3,49,600	Total		3,49,600

(b) Realisation Account

Dr. *Cr.*

Particulars	*Amount*	*Particulars*	*Amount*
To Sundry Assets:		By Creditors	60,000
Plant	1,52,000	By Bank Overdraft	40,000
Building	45,600		
Stock	84,000	By PQ Limited A/c	3,79,600
Debtors	68,000	(working note 2)	
To Profit:			
P's Capital A/c	65,000		
Q's Capital A/c	65,000		
	4,79,600		4,79,600

(c) Partner's Capital Accounts

Date	*Particulars*	*P (₹)*	*Q (₹)*	*Date*	*Particulars*	*P (₹)*	*Q (₹)*
01.01.14	To Profit & Loss A/c	15,000	15,000	1.1.14	By Balance b/d	1,50,000	1,30,000
01.01.14	To Drawing A/c	9,000	7,000	30.06.14	By Profit (W. N. 1)	15,600	15,600
30.06.14	To Drawing A/c (W. N.1)	7,800	7,800				
30.06.14	To Balance c/d	1,33,800	1,15,800				
	Total	1,65,600	1,45,600		Total	1,65,600	1,45,600
				30.06.14	By Balance b/d	1,33,800	1,15,800

30.06.14	To Shares in PQ Limited	1,98,800	180,800	30.06.14	By Realisation A/c (Profit)	65,000	65,000
		1,98,800	1,80,800			1,98,800	1,80,800

Working Notes

(1) Ascertainment of profit for the period of 6 Months ended 30.06.2014

		Amount (₹)
Closing Assets:		
Stock		84,000
Debtors		68,000
Plant Less Depreciation		1,52,000
Building Less Written off		45,600
Total		3,49,600
Less: Closing Liabilities:		
Creditors	60,000	
Bank Overdraft	40,000	1,00,000
Closing Net Assets		2,49,600
Less: Opening adjusted Capitals		
P (₹1,50,000 – ₹15,000 – ₹9,000)	1,26,000	
Q (₹1,30,000 – ₹15,000 – ₹7,000)	1,08,000	2,34,000
Profit Net of drawings		15,600
Actual Profit for Six Months before drawings(half of profit) = 15,600 x 2		31,200
Combined Drawing during six months (half of profit)		15,600

(2) Ascertainment of purchase consideration

	₹
Closing Net Assets (As above)	2,49,600
Add: Goodwill	1,30,000
Total Purchase Consideration	3,79,600

Summary

- Amalgamation of partnership firms includes
  - Closing the old books of Amalgamating firms
  - Opening the new books of Amalgamated firm
- When one firm is merged with another existing firm, entries will be in the pattern of winding up in the books of the firm which has ceased to exist. The other firm will record the transaction as that of a business purchase.
- Creditors play an important role in conversion of partnership firm into company.

APPENDIX – I

Framework for the Preparation and Presentation of Financial Statements*

The following is the text of the 'Framework for the Preparation and Presentation of Financial Statements' issued by the Accounting Standards Board of the Institute of Chartered Accountants of India.

Introduction

Purpose and Status

1. This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:

(a) assist preparers of financial statements in applying Accounting Standards and in dealing with topics that have yet to form the subject of an Accounting Standard;

(b) assist the Accounting Standards Board in the development of future Accounting Standards and in its review of existing Accounting Standards;

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

(d) assist auditors in forming an opinion as to whether financial statements conform with Accounting Standards;

(e) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with Accounting Standards; and

(f) provide those who are interested in the work of the Accounting

Standards Board with information about its approach to the formulation of Accounting Standards.

1. This Framework is not an Accounting Standard and hence does not define standards for any particular measurement or disclosure issue. Nothing in this Framework overrides any specific Accounting Standard.
2. The Accounting Standards Board recognises that in a limited number of cases there may be a conflict between the Framework and an Accounting Standard. In those cases where there is a conflict, the requirements of the Accounting Standard prevail over those of the Framework. As, however, the Accounting Standards Board will be guided by the Framework in the development of future Standards and in its review of existing Standards, the number of cases of conflict between the Framework and Accounting Standards will diminish through time.
3. The Framework will be revised from time to time on the basis of the experience of the Accounting Standards Board of working with it.

*Issued in July 2000.

Scope

5. The Framework deals with:

(a) the objective of financial statements;

(b) the qualitative characteristics that determine the usefulness of information provided in financial statements;

(c) definition, recognition and measurement of the elements from which financial statements are constructed; and

(d) concepts of capital and capital maintenance.

6. The Framework is concerned with general purpose financial statements (hereafter referred to as 'financial statements'). Such financial statements are prepared and presented at least annually and are directed toward the common information needs of a wide range of users. Some of these users may require, and have the power to obtain, information in addition to that contained in the financial statements. Many users, however, have to rely on the financial statements as their major source of financial information and such financial statements should, therefore, be prepared and presented with their needs in view. Special purpose financial reports, for example, prospectuses and computations prepared for taxation purposes, are outside the scope of this Framework. Nevertheless, the Framework may be applied in the preparation of such special purpose reports where their requirements permit.

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

8. The Framework applies to the financial statements of all reporting enterprises engaged in commercial, industrial and business activities, whether in the public or in the private sector. A reporting enterprise is an enterprise for which there are users who rely on the financial statements as their major source of financial information about the enterprise.

Users and Their Information Needs

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

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

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

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

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

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

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

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

10. While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As providers of risk capital to the enterprise, investors need more comprehensive information than other users. The provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

11. The management of an enterprise has the responsibility for the preparation and presentation of the financial statements of the enterprise. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this Framework.

The Objective of Financial Statements

1. The objective of financial statements is to provide information about the financial position, performance and cash flows of an enterprise that is useful to a wide range of users in making economic decisions.
2. Financial statements prepared for this purpose meet the common needs of most users. However, financial statements do not provide all the information that users may need to make economic decisions since (a) they largely portray the financial effects of past events, and (b) do not necessarily provide non-financial information.
3. Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the enterprise or whether to reappoint or replace the management.

Financial Position, Performance and Cash Flows

15. The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation. This ability ultimately determines, for example, the capacity of an enterprise to pay its employees and suppliers, meet interest payments, repay loans, and make distributions to its owners. Users are better able to evaluate this ability to generate cash and cash equivalents if they are provided with information that focuses on the financial position, performance and cash flows of an enterprise.

16. The financial position of an enterprise is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates. Information about the economic resources controlled by the enterprise and its capacity in the past to alter these resources is useful in predicting the ability of the enterprise to generate cash and cash equivalents in the future. Information about financial structure is useful in predicting future borrowing needs and how future profits and cash flows will be distributed among those with an interest in the enterprise; it is also useful in predicting how successful the enterprise is likely to be in raising further finance. Information about liquidity and solvency is useful in predicting the ability of the enterprise to meet its financial commitments as they fall due. Liquidity refers to the availability of cash in the near future to meet financial commitments over this period. Solvency refers to the availability of cash over the longer term to meet financial commitments as they fall due.

17. Information about the performance of an enterprise, in particular its profitability, is required in order to assess potential changes in the economic resources that it is likely to control in the future. Information about variability of performance is important in this respect. Information about performance is useful in predicting the capacity of the enterprise to generate cash flows from its existing resource base. It is also useful in forming judgements about the effectiveness with which the enterprise might employ additional resources.

18. Information concerning cash flows of an enterprise is useful in order to evaluate its investing, financing and operating activities during the reporting period. This information is useful in providing the users with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilise those cash flows.

19. Information about financial position is primarily provided in a balance sheet. Information about performance is primarily provided in a statement of profit and loss. Information about cash flows is provided in the financial statements by means of a cash flow statement.

20. The component parts of the financial statements are interrelated because they reflect different aspects of the same transactions or other events. Although each statement provides information that is different from the others, none is likely to serve only a single purpose nor to provide all the information necessary for particular needs of users.

Notes and Supplementary Schedules

21. The financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and statement of profit and loss. They may include disclosures about the risks and uncertainties affecting the enterprise and any resources and obligations not recognised in the balance sheet (such as mineral reserves). Information about business and geographical segments and the effect of changing prices on the enterprise may also be provided in the form of supplementary information.

Underlying Assumptions

Accrual Basis

22. In order to meet their objectives, financial statements are prepared on the accrual basis of accounting. Under this basis, the effects of transactions and other events are recognised when they occur (and not as cash or a cash equivalent is received or paid) and they are recorded in the accounting records and reported in the financial statements of the periods to which they relate. Financial statements prepared on the accrual basis inform users not only of past events involving the payment and receipt of cash but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

Going Concern

23. The financial statements are normally prepared on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the enterprise has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

Consistency

24. In order to achieve comparability of the financial statements of an enterprise through time, the accounting policies are followed consistently from one period to another; a change in an accounting policy is made only in certain exceptional circumstances.

Qualitative Characteristics of Financial Statements

25. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

Understandability

26. An essential quality of the information provided in financial statements is that it must be readily understandable by users. For this purpose, it is assumed that users have a reasonable knowledge of business and economic activities and accounting and study the information with reasonable diligence. Information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the ground that it may be too difficult for certain users to understand.

Relevance

27. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.

28. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the enterprise to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the enterprise would be structured or the outcome of planned operations.

29. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly

interested, such as dividend and wage payments, share price movements and the ability of the enterprise to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the statement of profit and loss is enhanced if unusual, abnormal and infrequent items of income and expense are separately disclosed.

Materiality

30. The relevance of information is affected by its materiality. Information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality depends on the size and nature of the item or error, judged in the particular circumstances of its misstatement. Materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which the information must have if it is to be useful.

Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action against the enterprise are highly uncertain, it may be inappropriate for the enterprise to recognise the amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

Faithful Representation

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the enterprise at the reporting date which meet the recognition criteria.

34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that enterprises generally would not recognise them in the financial statements; for example, although most enterprises generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Substance Over Form

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, where

rights and beneficial interest in an immovable property are transferred but the documentation and legal formalities are pending, the recording of acquisition/disposal (by the transferee and transferor respectively) would in substance represent the transaction entered into.

Neutrality

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Prudence

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

Completeness

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

Comparability

39. Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position, performance and cash flows. Users must also be able to compare the financial statements of different enterprises in order to evaluate their relative financial position, performance and cash flows. Hence, the measurement and display of the financial effects of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time for that enterprise and in a consistent way for different enterprises.

40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same enterprise from period to period and by different enterprises. Compliance with Accounting Standards, including the disclosure of the accounting policies used by the enterprise, helps to achieve comparability.

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an enterprise to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an enterprise to leave its accounting policies unchanged when more relevant and reliable alternatives exist.

42. Users wish to compare the financial position, performance and cash flows of an enterprise over time. Hence, it is important that the financial statements show corresponding information for the preceding period(s).

Constraints on Relevant and Reliable Information

Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the information needs of users.

Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

Balance between Qualitative Characteristics

45. In practice, a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

True and Fair View

46. Financial statements are frequently described as showing a true and fair view of the financial position, performance and cash flows of an enterprise. Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of such information.

The Elements of Financial Statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the statement of profit and loss are income and expenses. The cash flow statement usually reflects elements of statement of profit and loss and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.

48. The presentation of these elements in the balance sheet and the statement of profit and loss involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:

(a) An *asset* is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

(b) A *liability* is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

(c) *Equity* is the residual interest in the assets of the enterprise after deducting all its liabilities.

50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 81 to 97. In particular, the expectation that future economic benefits will flow to or from an enterprise must be sufficiently certain to meet the probability criterion in paragraph 82 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, consideration needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of hire purchase, the substance and economic reality are that the hire purchaser acquires the economic benefits of the use of the asset in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the hire purchase gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the hire purchaser's balance sheet.

Assets

52. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the enterprise. The potential may be a productive one that is part of the operating activities of the enterprise. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

53. An enterprise usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flows of the enterprise. Cash itself renders a service to the enterprise because of its command over other resources.

54. The future economic benefits embodied in an asset may flow to the enterprise in a number of ways. For example, an asset may be:

- (a) used singly or in combination with other assets in the production of goods or services to be sold by the enterprise;
- (b) exchanged for other assets;
- (c) used to settle a liability; or
- (d) distributed to the owners of the enterprise.

55. Many assets, for example, plant and machinery, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them and if they are controlled by the enterprise.

56. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, an item held under a hire purchase is an asset of the hire purchaser since the hire purchaser controls the benefits which are expected to flow from the item. Although the capacity of an enterprise to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an enterprise controls the benefits that are expected to flow from it.

57. The assets of an enterprise result from past transactions or other past events. Enterprises normally obtain assets by purchasing or producing them, but other transactions or events may also generate assets; examples include land received by an enterprise from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or other events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

58. There is a close association between incurring expenditure and obtaining assets but the two do not necessarily coincide. Hence, when an enterprise incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly, the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet.

Liabilities

59. An essential characteristic of a liability is that the enterprise has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an enterprise decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.

60. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an enterprise to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the enterprise enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the enterprise with little, if any, discretion to avoid the outflow of resources to another party.

61. The settlement of a present obligation usually involves the enterprise giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:

(a) payment of cash;

(b) transfer of other assets;

(c) provision of services;

(d) replacement of that obligation with another obligation; or

(e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

62. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade creditors (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.

63. Some liabilities can be measured only by using a substantial degree of estimation. Such liabilities are commonly described as 'provisions'. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

Equity

64. Although equity is defined in paragraph 49 as a residual, it may be subclassified in the balance sheet. For example, funds contributed by owners, reserves representing appropriations of retained earnings, unappropriated retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the enterprise to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an enterprise have differing rights in relation to the receipt of dividends or the repayment of capital.

65. The creation of reserves is sometimes required by law in order to give the enterprise and its creditors an added measure of protection from the effects of losses. Reserves may also be created when tax laws grant exemptions from, or reductions in, taxation liabilities if transfers to such reserves are made. The existence and size of such reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

66. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the enterprise or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the enterprise as a whole on a going concern basis.

67. Commercial, industrial and business activities are often undertaken by means of enterprises such as sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such enterprises is often different from that applicable to corporate enterprises. For example, unlike corporate enterprises, in the case of such enterprises, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such enterprises.

Performance

68. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the enterprise in preparing its financial statements. These concepts are discussed in paragraphs 101 to 109.

69. Income and expenses are defined as follows:

(a) *Income* is increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) *Expenses* are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

70. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the statement of profit and loss. Criteria for recognition of income and expenses are discussed in paragraphs 81 to 97.

71. Income and expenses may be presented in the statement of profit and loss in different ways so as to provide information that is relevant for economic decision-making. For example, it is a common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the enterprise and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the enterprise to generate cash and cash equivalents in the future. When distinguishing between items in this way, consideration needs to be given to the nature of the enterprise and its operations. Items that arise from the ordinary activities of one enterprise may be extraordinary in respect of another.

72. Distinguishing between items of income and expense and combining them in different ways also permits several measures of enterprise performance to be displayed. These have differing degrees of inclusiveness.

For example, the statement of profit and loss could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

Income

73. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an enterprise and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

74. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an enterprise. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as a separate element in this Framework.

75. The definition of income includes unrealised gains. Gains also include, for example, those arising on the disposal of fixed assets. When gains are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

76. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result in the settlement of liabilities. For example, an enterprise may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

Expenses

77. The definition of expenses encompasses those expenses that arise in the course of the ordinary activities of the enterprise, as well as losses. Expenses that arise in the course of the ordinary activities of the enterprise include, for example, cost of goods sold, wages, and depreciation. They take the form of an outflow or depletion of assets or enhancement of liabilities.

78. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the enterprise. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.

79. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of fixed assets. The definition of expenses also includes unrealised losses. When losses are recognised in the statement of profit and loss, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

Capital Maintenance Adjustments

80. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the statement of profit and loss under certain concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 101 to 109 of this Framework.

Recognition of the Elements of Financial Statements

81. Recognition is the process of incorporating in the balance sheet or statement of profit and loss an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 82. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the totals of balance sheet or statement of profit and loss. Items that satisfy the recognition criteria should be recognised in the balance sheet or statement of profit and loss. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.

82. An item that meets the definition of an element should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; and

(b) the item has a cost or value that can be measured with reliability.

83. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraph 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example, an asset, automatically requires the recognition of another element, for example, income or a liability.

The Probability of Future Economic Benefits

84. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the enterprise. The concept is in keeping with the uncertainty that characterises the environment in which an enterprise operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable will be realised, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence, an expense representing the expected reduction in economic benefits is recognised.

Reliability of Measurement

85. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made, the item is not recognised in the balance sheet or statement of profit and loss. For example, the damages payable in a lawsuit may meet the definitions of both a liability and an expense as well as the probability criterion for recognition; however, if it is not possible to measure the claim reliably, it should not be recognised as a liability or as an expense.

86. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 82 may qualify for recognition at a later date as a result of subsequent circumstances or events.

87. An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or supplementary schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and cash flows of an enterprise by the users of financial statements. Thus, in the example given in paragraph 85, the existence of the claim would need to be disclosed in the notes, explanatory material or supplementary schedules.

Recognition of Assets

88. An asset is recognised in the balance sheet when it is probable that the future economic benefits associated with it will flow to the enterprise and the asset has a cost or value that can be measured reliably.

89. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the enterprise beyond the current accounting period. Instead, such a transaction results in the recognition of an expense in the statement of profit and loss. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the enterprise or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the enterprise beyond the current accounting period is insufficient to warrant the recognition of an asset.

Recognition of Liabilities

90. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

Recognition of Income

91. Income is recognised in the statement of profit and loss when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

92. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

Recognition of Expenses

93. Expenses are recognised in the statement of profit and loss when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase of liabilities or a decrease in assets (for example, the accrual of employees' salaries or the depreciation of plant and machinery).

94. Many expenses are recognised in the statement of profit and loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.

95. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the statement of profit and loss on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as plant and machinery, goodwill, patents and trademarks; in such cases, the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

96. An expense is recognised immediately in the statement of profit and loss when an expenditure produces no future economic benefits. An expense is also recognised to the extent that future economic benefits from an expenditure do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.

97. An expense is recognised in the statement of profit and loss in those cases also where a liability is incurred without the recognition of an asset, for example, in the case of a liability under a product warranty.

Measurement of the Elements of Financial Statements

98. Measurement is the process of determining the monetary amounts at which the elements of financial statements are to be recognised and carried in the balance sheet and statement of profit and loss. This involves the selection of the particular basis of measurement.

99. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

   (a) *Historical cost*. Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) *Current cost*. Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset were acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) *Realisable (settlement) value*. Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amounts of cash or cash equivalents expected to be required to settle the liabilities in the normal course of business.

(d) *Present value*. Assets are carried at the present value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

100. The measurement basis most commonly adopted by enterprises in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value and pension liabilities are carried at their present value. Furthermore, the current cost basis may be used as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

Concepts of Capital and Capital Maintenance

Concepts of Capital

101. Under a financial concept of capital, such as invested money or invested purchasing power, capital is synonymous with the net assets or equity of the enterprise. Under a physical concept of capital, such as operating capability, capital is regarded as the productive capacity of the enterprise based on, for example, units of output per day.

102. The selection of the appropriate concept of capital by an enterprise should be based on the needs of the users of its financial statements. Thus, a financial concept of capital should be adopted if the users of financial statements are primarily concerned with the maintenance of nominal invested capital or the purchasing power of invested capital. If, however, the main concern of users is with the operating capability of the enterprise, a physical concept of capital should be used. The concept chosen indicates the goal to be attained in determining profit, even though there may be some measurement difficulties in making the concept operational.

Concepts of Capital Maintenance and the Determination of Profit

103. The concepts of capital described in paragraph 101 give rise to the following concepts of capital maintenance:

(a) *Financial capital maintenance*. Under this concept, a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical capital maintenance*. Under this concept, a profit is earned only if the physical productive capacity (or operating capability) of the enterprise at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

104. The concept of capital maintenance is concerned with how an enterprise defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured; it is a prerequisite for distinguishing between an enterprise's return *on* capital and its return *of* capital; only inflows of assets in excess of amounts needed to maintain capital can be regarded as profit and therefore as a return on capital. Hence, profit is the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income. If expenses exceed income, the residual amount is a net loss.

105. The physical capital maintenance concept requires the adoption of the current cost basis of measurement. The financial capital maintenance concept, however, does not require the use of a particular basis of measurement. Selection of the basis under this concept is dependent on the type of financial capital that the enterprise is seeking to maintain.

106. The principal difference between the two concepts of capital maintenance is the treatment of the effects of changes in the prices of assets and liabilities of the enterprise. In general terms, an enterprise has maintained its capital if it has as much capital at the end of the period as it had at the beginning of the period. Any amount over and above that required to maintain the capital at the beginning of the period is profit.

107. Under the concept of financial capital maintenance where capital is defined in terms of nominal monetary units, profit represents the increase in nominal money capital over the period. Thus, increases in the prices of assets held over the period, conventionally referred to as holding gains, are, conceptually, profits. They may not be recognised as such, however, until the assets are disposed of in an exchange transaction. When the concept of financial capital maintenance is defined in terms of constant purchasing power units, profit represents the increase in invested purchasing power over the period. Thus, only that part of the increase in the prices of assets that exceeds the increase in the general level of prices is regarded as profit. The rest of the increase is treated as a capital maintenance adjustment and, hence, as part of equity.

108. Under the concept of physical capital maintenance when capital is defined in terms of the physical productive capacity, profit represents the increase in that capital over the period. All price changes affecting the assets and liabilities of the enterprise are viewed as changes in the measurement of the physical productive capacity of the enterprise; hence, they are treated as capital maintenance adjustments that are part of equity and not as profit.

109. The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This Framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements under the chosen model.

APPENDIX – II

Applicability of Accounting Standards to Various Entities

(including criteria for classification of entities)

Applicability of Accounting Standards to Companies

(I) Accounting Standards applicable to all companies in their entirety

AS 1	Disclosures of Accounting Policies
AS 2	Valuation of Inventories
AS 4	Contingencies and Events Occurring After the Balance Sheet Date
AS 5	Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies
AS 6	Depreciation Accounting
AS 7	Construction Contracts (revised 2002)
AS 9	Revenue Recognition
AS 10	Accounting for Fixed Assets
AS 11	The Effects of Changes in Foreign Exchange Rates (revised 2003)
AS 12	Accounting for Government Grants
AS 13	Accounting for Investments
AS 14	Accounting for Amalgamations
AS 16	Borrowing Costs
AS 18	Related Party Disclosures
AS 22	Accounting for Taxes on Income
AS 24	Discontinuing Operations
AS 26	Intangible Assets

(II) Exemptions or Relaxations for SMCs as defined in the Notification

(A) Accounting Standards not applicable to SMCs in their entirety:

AS 3	Cash Flow Statements.
AS 17	Segment Reporting

(B) Accounting Standards not applicable to SMCs since the relevant Regulations require compliance with them only by certain Non-SMCs[1]:

---

[1] AS 21, AS 23 and AS 27 (relating to consolidated financial statements) are required to be complied with by a company if the company, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(i) AS 21 Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(C) Accounting Standards in respect of which relaxations from certain requirements have been given to SMCs:

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such companies should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such companies should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such companies should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(ii) AS 19, Leases

Paragraphs 22 (c), (e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to SMCs.

(iii) AS 20, Earnings Per Share

Disclosure of diluted earnings per share (both including and excluding extraordinary items) is exempted for SMCs.

(iv) AS 28, Impairment of Assets

SMCs are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if an SMC chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an SMC. Further, such an SMC need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to SMCs.

(D) AS 25, Interim Financial Reporting, does not require a company to present interim financial report. It is applicable only if a company is required or elects to prepare and present an interim financial report. Only certain Non-SMCs are required by the concerned regulators to present interim financial results, e.g, quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Non-SMCs for preparation of interim financial results.

Applicability of Accounting Standards to Non-corporate Entities

(I) Accounting Standards applicable to all Non- corporate Entities in their entirety (Level I, Level II and Level III)

AS 1 Disclosures of Accounting Policies

AS 2 Valuation of Inventories

AS 4 Contingencies and Events Occurring After the Balance Sheet Date

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

AS 6 Depreciation Accounting

AS 7 Construction Contracts (revised 2002)

AS 9 Revenue Recognition

AS 10 Accounting for Fixed Assets

AS 11 The Effects of Changes in Foreign Exchange Rates (revised 2003)

AS 12 Accounting for Government Grants

AS 13 Accounting for Investments

AS 14 Accounting for Amalgamations

AS 16 Borrowing Costs

AS 22 Accounting for Taxes on Income

AS 26 Intangible Assets

(II) Exemptions or Relaxations for Non-corporate Entities falling in Level II and Level III (SMEs)

(A) Accounting Standards not applicable to Non-corporate Entities falling in Level II in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

(B) Accounting Standards not applicable to Non-corporate Entities falling in Level III in their entirety:

AS 3 Cash Flow Statements

AS 17 Segment Reporting

AS 18 Related Party Disclosures

AS 24 Discontinuing Operations

(C) Accounting Standards not applicable to all Non-corporate Entities since the relevant Regulators require compliance with them only by certain Level I entities:[2]

(i) AS 21, Consolidated Financial Statements

(ii) AS 23, Accounting for Investments in Associates in Consolidated Financial Statements

(iii) AS 27, Financial Reporting of Interests in Joint Ventures (to the extent of requirements relating to Consolidated Financial Statements)

(D) Accounting Standards in respect of which relaxations from certain requirements have been given to Non-corporate Entities falling in Level II and Level III (SMEs):

(i) Accounting Standard (AS) 15, Employee Benefits (revised 2005)

(1) Level II and Level III Non-corporate entities whose average number of persons employed during the year is 50 or more are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities should actuarially determine and provide for the accrued liability in respect of defined benefit plans by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard. Such entities should disclose actuarial assumptions as per paragraph 120(l) of the Standard; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. However, such entities should actuarially determine and provide for the accrued liability in respect of other long-term employee benefits by using the Projected Unit Credit Method and the discount rate used should be determined by reference to market yields at the balance sheet date on government bonds as per paragraph 78 of the Standard.

(2) Level II and Level III Non-corporate entities whose average number of persons employed during the year is less than 50 are exempted from the applicability of the following paragraphs:

(a) paragraphs 11 to 16 of the standard to the extent they deal with recognition and measurement of short-term accumulating compensated absences which are non-vesting (i.e., short-term accumulating compensated absences in respect of which employees are not entitled to cash payment for unused entitlement on leaving);

---

[2] AS 21, AS 23 and AS 27 (to the extent these standards relate to preparation of consolidated financial statements) are required to be complied with by a non-corporate entity if the non-corporate entity, pursuant to the requirements of a statute/regulator or voluntarily, prepares and presents consolidated financial statements.

(b) paragraphs 46 and 139 of the Standard which deal with discounting of amounts that fall due more than 12 months after the balance sheet date;

(c) recognition and measurement principles laid down in paragraphs 50 to 116 and presentation and disclosure requirements laid down in paragraphs 117 to 123 of the Standard in respect of accounting for defined benefit plans. However, such entities may calculate and account for the accrued liability under the defined benefit plans by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year; and

(d) recognition and measurement principles laid down in paragraphs 129 to 131 of the Standard in respect of accounting for other long-term employee benefits. Such entities may calculate and account for the accrued liability under the other long-term employee benefits by reference to some other rational method, e.g., a method based on the assumption that such benefits are payable to all employees at the end of the accounting year.

(ii) AS 19, Leases

Paragraphs 22 (c),(e) and (f); 25 (a), (b) and (e); 37 (a) and (f); and 46 (b) and (d) relating to disclosures are not applicable to non- corporate entities falling in Level II and 46 (b), (d) and (e) relating to disclosures are not applicable to Level III entities.

(iii) AS 20, Earnings Per Share

Diluted earnings per share (both including and excluding extraordinary items) is not required to be disclosed by non-corporate entities falling in Level II and Level III and information required by paragraph 48(ii) of AS 20 is not required to be disclosed by Level III entities if this standard is applicable to these entities.

(iv) AS 28, Impairment of Assets

Non-corporate entities falling in Level II and Level III are allowed to measure the 'value in use' on the basis of reasonable estimate thereof instead of computing the value in use by present value technique. Consequently, if a non-corporate entity falling in Level II or Level III chooses to measure the 'value in use' by not using the present value technique, the relevant provisions of AS 28, such as discount rate etc., would not be applicable to such an entity. Further, such an entity need not disclose the information required by paragraph 121(g) of the Standard.

(v) AS 29, Provisions, Contingent Liabilities and Contingent Assets

Paragraphs 66 and 67 relating to disclosures are not applicable to non-corporate entities falling in Level II and Level III.

(E) AS 25, Interim Financial Reporting, does not require a non-corporate entity to present interim financial report. It is applicable only if a non- corporate entity is required or elects to prepare and present an interim financial report. Only certain Level I non-corporate entities are required by the concerned regulators to present interim financial results, e.g., quarterly financial results required by the SEBI. Therefore, the recognition and measurement requirements contained in this Standard are applicable to those Level I non-corporate entities for preparation of interim financial results.

Criteria for classification of entities

Criteria for classification of companies under the Companies (Accounting Standards) Rules, 2006

Small and Medium-Sized Company (SMC) as defined in Clause 2(f) of the Companies (Accounting Standards) Rules, 2006:

"Small and Medium Sized Company" (SMC) means, a company-

(i) whose equity or debt securities are not listed or are not in the process of listing on any stock exchange, whether in India or outside India;

(ii) which is not a bank, financial institution or an insurance company;

(iii) whose turnover (excluding other income) does not exceed rupees fifty crore in the immediately preceding accounting year;

(iv) which does not have borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year; and

(v) which is not a holding or subsidiary company of a company which is not a small and medium-sized company.

Explanation: For the purposes of clause (f), a company shall qualify as a Small and Medium Sized Company, if the conditions mentioned therein are satisfied as at the end of the relevant accounting period.

Non-SMCs

Companies not falling within the definition of SMC are considered as Non- SMCs.

Instructions

A. General Instructions

1. SMCs shall follow the following instructions while complying with Accounting Standards under these Rules:- the exemptions or relaxations given to it shall disclose (by way of a note to its financial statements) the fact that it is an SMC and has complied with the Accounting Standards insofar as they are applicable to an SMC on the following lines:

"The Company is a Small and Medium Sized Company (SMC) as defined in the General Instructions in respect of Accounting Standards notified under the Companies Act, 1956. Accordingly, the Company has complied with the Accounting Standards as applicable to a Small and Medium Sized Company."

1.2 Where a company, being an SMC, has qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be an SMC. The fact that the company was an SMC in the previous period and it had availed of the exemptions or relaxations available to SMCs shall be disclosed in the notes to the financial statements.

1.3 If an SMC opts not to avail of the exemptions or relaxations available to an SMC in respect of any but not all of the Accounting Standards, it shall disclose the standard(s) in respect of which it has availed the exemption or relaxation.

1.4 If an SMC desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to the SMCs, it shall disclose that information in compliance with the relevant accounting standard.

1.5 The SMC may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure shall not be permitted to mislead any person or public.

B. Other Instructions

Rule 5 of the Companies (Accounting Standards) Rules, 2006, provides as below:

"5. An existing company, which was previously not a Small and Medium Sized Company (SMC) and subsequently becomes an SMC, shall not be qualified for exemption or relaxation in respect of Accounting Standards available to an SMC until the company remains an SMC for two consecutive accounting periods."

Criteria for classification of non-corporate entities as decided by the Institute of Chartered Accountants of India

Level I Entities

Non-corporate Entities which fall in any one or more of the following categories, at the end of the relevant accounting period, are classified as Level I entities:

(i) Entities whose equity or debt securities are listed or are in the process of listing on any stock exchange, whether in India or outside India.

(ii) Banks (including co-operative banks), financial institutions or entities carrying on insurance business.

(iii) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees fifty crore in the immediately preceding accounting year.

(iv) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees ten crore at any time during the immediately preceding accounting year.

(v) Holding and subsidiary entities of any one of the above.

Level II Entities (SMEs)

Non-corporate Entities which are not Level I entities but fall in any one or more of the following categories are classified as Level II entities:

(i) All commercial, industrial and business reporting entities, whose turnover (excluding other income) exceeds rupees ***one crore**** but does not exceed rupees fifty crore in the immediately preceding accounting year.

---

* *Earlier this limit was Rupees 40 lakhs which has been raised to Rupees One Crore as as per the announcement "Revision in the Criteria for classifying Level II Non-Corporate Entities" issued by ICAI on 7th March, 2013. This revision is applicable with effect from the accounting year commencing on or after April 1, 2012.*

(ii) All commercial, industrial and business reporting entities having borrowings (including public deposits) in excess of rupees one crore but not in excess of rupees ten crore at any time during the immediately preceding accounting year.

(iii) Holding and subsidiary entities of any one of the above.

Level III Entities (SMEs)

Non-corporate Entities which are not covered under Level I and Level II are considered as Level III entities.

Additional requirements

(1) An SME which does not disclose certain information pursuant to the exemptions or relaxations given to it should disclose (by way of a note to its financial statements) the fact that it is an SME and has complied with the Accounting Standards insofar as they are applicable to entities falling in Level II or Level III, as the case may be.

(2) Where an entity, being covered in Level II or Level III, had qualified for any exemption or relaxation previously but no longer qualifies for the relevant exemption or relaxation in the current accounting period, the relevant standards or requirements become applicable from the current period and the figures for the corresponding period of the previous accounting period need not be revised merely by reason of its having ceased to be covered in Level II or Level III, as the case may be. The fact that the entity was covered in Level II or Level III, as the case may be, in the previous period and it had availed of the exemptions or relaxations available to that Level of entities should be disclosed in the notes to the financial statements.

(3) Where an entity has been covered in Level I and subsequently, ceases to be so covered, the entity will not qualify for exemption/relaxation available to Level II entities, until the entity ceases to be covered in Level I for two consecutive years. Similar is the case in respect of an entity, which has been covered in Level I or Level II and subsequently, gets covered under Level III.

(4) If an entity covered in Level II or Level III opts not to avail of the exemptions or relaxations available to that Level of entities in respect of any but not all of the Accounting Standards, it should disclose the Standard(s) in respect of which it has availed the exemption or relaxation.

(5) If an entity covered in Level II or Level III desires to disclose the information not required to be disclosed pursuant to the exemptions or relaxations available to that Level of entities, it should disclose that information in compliance with the relevant Accounting Standard.

(6) An entity covered in Level II or Level III may opt for availing certain exemptions or relaxations from compliance with the requirements prescribed in an Accounting Standard:

Provided that such a partial exemption or relaxation and disclosure should not be permitted to mislead any person or public.

(7) In respect of Accounting Standard (AS) 15, Employee Benefits, exemptions/ relaxations are available to Level II and Level III entities, under two sub-classifications, viz., (i) entities whose average number of persons employed during the year is 50 or more, and (ii) entities whose average number of persons employed during the year is less than 50. The requirements stated in paragraphs (1) to (6) above, mutatis mutandis, apply to these sub-classifications.

APPENDIX – III

AS 4* : Contingencies[1] and Events Occurring After the Balance Sheet Date

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[2] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

1. This Standard deals with the treatment in financial statements of

   (a) contingencies[3], and

   (b) events occurring after the balance sheet date.

2. The following subjects, which may result in contingencies, are excluded from the scope of this Standard in view of special considerations applicable to them:

   (a) liabilities of life assurance and general insurance enterprises arising from policies issued;

   (b) obligations under retirement benefit plans; and

   (c) commitments arising from long-term lease contracts.

Definitions

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

3.1 A contingency is a condition or situation, the ultimate outcome of which, gain or loss, will be known or determined only on the occurrence, or non-occurrence, of one or more uncertain future events.

3.2 Events occurring after the balance sheet date are those significant events, both favourable and unfavourable, that occur between the balance sheet date and the date on which the financial statements are approved by the Board of Directors in the case of a company, and, by the corresponding approving authority in the case of any other entity.

---

* Revised in 1995.

[1] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets becoming mandatory in respect of accounting periods commencing on or after 1-4-2004, all paragraphs of this Standard that deal with contingencies (viz. paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5 (5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant portion), 9.2, 10, 11, 12 and 16) stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. For example, impairment of receivables (commonly referred to as the provision for bad and doubtful debts), would continue to be covered by AS 4.

[2] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[3] See footnote 1

Two types of events can be identified:

(a) those which provide further evidence of conditions that existed at the balance sheet date; and

(b) those which are indicative of conditions that arose subsequent to the balance sheet date.

Explanation

4. Contingencies

4.1 The term "contingencies" used in this Standard is restricted to conditions or situations at the balance sheet date, the financial effect of which is to be determined by future events which may or may not occur.

4.2 Estimates are required for determining the amounts to be stated in the financial statements for many on-going and recurring activities of an enterprise. One must, however, distinguish between an event which is certain and one which is uncertain. The fact that an estimate is involved does not, of itself, create the type of uncertainty which characterises a contingency. For example, the fact that estimates of useful life are used to determine depreciation does not make depreciation a contingency; the eventual expiry of the useful life of the asset is not uncertain. Also, amounts owed for services received are not contingencies as defined in paragraph 3.1, even though the amounts may have been estimated, as there is nothing uncertain about the fact that these obligations have been incurred.

4.3 The uncertainty relating to future events can be expressed by a range of outcomes. This range may be presented as quantified probabilities, but in most circumstances, this suggests a level of precision that is not supported by the available information. The possible outcomes can, therefore, usually be generally described except where reasonable quantification is practicable.

4.4 The estimates of the outcome and of the financial effect of contingencies are determined by the judgement of the management of the enterprise. This judgement is based on consideration of information available up to the date on which the financial statements are approved and will include a review of events occurring after the balance sheet date, supplemented by experience of similar transactions and, in some cases, reports from independent experts.

5. Accounting Treatment of Contingent Losses

5.1 The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements.

5.2 The estimation of the amount of a contingent loss to be provided for in the financial statements may be based on information referred to in paragraph 4.4.

5.3 If there is conflicting or insufficient evidence for estimating the amount of a contingent loss, then disclosure is made of the existence and nature of the contingency.

5.4 A potential loss to an enterprise may be reduced or avoided because a contingent liability is matched by a related counter-claim or claim against a third party. In such cases, the amount of the provision is determined after taking into account the probable recovery under the claim if no significant uncertainty as to its measurability or collectability exists. Suitable disclosure regarding the nature and gross amount of the contingent liability is also made.

5.5 The existence and amount of guarantees, obligations arising from discounted bills of exchange and similar obligations undertaken by an enterprise are generally disclosed in financial statements by way of note, even though the possibility that a loss to the enterprise will occur, is remote.

5.6 Provisions for contingencies are not made in respect of general or unspecified business risks since they do not relate to conditions or situations existing at the balance sheet date.

6. Accounting Treatment of Contingent Gains

Contingent gains are not recognised in financial statements since their recognition may result in the recognition of revenue which may never be realised. However, when the realisation of a gain is virtually certain, then such gain is not a contingency and accounting for the gain is appropriate.

7. Determination of the Amounts at which Contingencies are included in Financial Statements

7.1 The amount at which a contingency is stated in the financial statements is based on the information which is available at the date on which the financial statements are approved. Events occurring after the balance sheet date that indicate that an asset may have been impaired, or that a liability may have existed, at the balance sheet date are, therefore, taken into account in identifying contingencies and in determining the amounts at which such contingencies are included in financial statements.

7.2 In some cases, each contingency can be separately identified, and the special circumstances of each situation considered in the determination of the amount of the contingency. A substantial legal claim against the enterprise may represent such a contingency. Among the factors taken into account by management in evaluating such a contingency are the progress of the claim at the date on which the financial statements are approved, the opinions, wherever necessary, of legal experts or other advisers, the experience of the enterprise in similar cases and the experience of other enterprises in similar situations.

7.3 If the uncertainties which created a contingency in respect of an individual transaction are common to a large number of similar transactions, then the amount of the contingency need not be individually determined, but may be based on the group of similar transactions. An example of such contingencies may be the estimated uncollectable portion of accounts receivable. Another example of such contingencies may be the warranties for products sold. These costs are usually incurred frequently and experience provides a means by which the amount of the liability or loss can be estimated with reasonable precision although the particular transactions that may result in a liability or a loss are not identified. Provision for these costs results in their recognition in the same accounting period in which the related transactions took place.

8. Events Occurring after the Balance Sheet Date

8.1 Events which occur between the balance sheet date and the date on which the financial statements are approved, may indicate the need for adjustments to assets and liabilities as at the balance sheet date or may require disclosure.

8.2 Adjustments to assets and liabilities are required for events occurring after the balance sheet date that provide additional information materially affecting the determination of the amounts relating to conditions existing at the balance sheet date. For example, an adjustment may be made for a loss on a trade receivable account which is confirmed by the insolvency of a customer which occurs after the balance sheet date.

8.3 Adjustments to assets and liabilities are not appropriate for events occurring after the balance sheet date, if such events do not relate to conditions existing at the balance sheet date. An example is the decline in market value of investments between the balance sheet date and the date on which the financial statements are approved. Ordinary fluctuations in market values do not normally relate to the condition of the investments at the balance sheet date, but reflect circumstances which have occurred in the following period.

8.4 Events occurring after the balance sheet date which do not affect the figures stated in the financial statements would not normally require disclosure in the financial statements although they may be of such significance that they may require a disclosure in the report of the approving authority to enable users of financial statements to make proper evaluations and decisions.

8.5 There are events which, although they take place after the balance sheet date, are sometimes reflected in the financial statements because of statutory requirements or because of their special nature. Such items include the amount of dividend proposed or declared by the enterprise after the balance sheet date in respect of the period covered by the financial statements.

8.6 Events occurring after the balance sheet date may indicate that the enterprise ceases to be a going concern. A deterioration in operating results and financial position, or unusual changes affecting the existence or substratum of the enterprise after the balance sheet date (e.g., destruction of a major production plant by a fire after the balance sheet date) may indicate a need to consider whether it is proper to use the fundamental accounting assumption of going concern in the preparation of the financial statements.

9. Disclosure

9.1 The disclosure requirements herein referred to apply only in respect of those contingencies or events which affect the financial position to a material extent.

9.2 If a contingent loss is not provided for, its nature and an estimate of its financial effect are generally disclosed by way of note unless the possibility of a loss is remote (other than the circumstances mentioned in paragraph 5.5). If a reliable estimate of the financial effect cannot be made, this fact is disclosed.

9.3 When the events occurring after the balance sheet date are disclosed in the report of the approving authority, the information given comprises the nature of the events and an estimate of their financial effects or a statement that such an estimate cannot be made.

Main Principles

Contingencies[4]

10. The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if:

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

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

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

12. Contingent gains should not be recognised in the financial statements.

Events Occurring after the Balance Sheet Date

13. Assets and liabilities should be adjusted for events occurring after the balance sheet date that provide additional evidence to assist the estimation of amounts relating to conditions

---

[4] See also footnote 1

existing at the balance sheet date or that indicate that the fundamental accounting assumption of going concern (i.e., the continuance of existence or substratum of the enterprise) is not appropriate.

14. Dividends stated to be in respect of the period covered by the financial statements, which are proposed or declared by the enterprise after the balance sheet date but before approval of the financial statements, should be adjusted.

15. Disclosure should be made in the report of the approving authority of those events occurring after the balance sheet date that represent material changes and commitments affecting the financial position of the enterprise.

Disclosure

16. If disclosure of contingencies is required by paragraph 11 of this Standard, the following information should be provided:

(a) the nature of the contingency;

(b) the uncertainties which may affect the future outcome;

(c) an estimate of the financial effect, or a statement that such an estimate cannot be made.

17. If disclosure of events occurring after the balance sheet date in the report of the approving authority is required by paragraph 15 of this Standard, the following information should be provided:

(a) the nature of the event;

(b) an estimate of the financial effect, or a statement that such an estimate cannot be made.

The ICAI has recently issued an Exposure Draft on Limited revision to Accounting Standard 4 "Events Occuring after the Balance Sheet Date". This Limited Revision has been issued due to the following reasons:

(i) To harmonise the requirements of AS 4, Contingencies and Events Occuring after the Balance Sheet Date, with the requirements of the revised Schedule VI to the Companies Act, 1956. As the disclosure of provision for proposed dividends is not required in the revised Schedule VI to the Companies Act, 1956 (Now Schedule III to the Companies Act, 2013) , paragraphs 8.5 and 14 have been modified.

(ii) Since the paragraphs dealing with contingencies were already substantially withdrawn by the ICAI when AS 29 became mandatory the provisions dealing with contingencies are deleted from AS 4.

(iii) To disclose the non-adjusting events occurring after the balance sheet date in the financial statements instead of in the report of the approving authority with a view to promote transparency in financial statements.

However, it is pertinent to note that this Limited Revision has not yet been notified by the Govt. This Limited Revision will come into effect as and when it will be notified by the Govt.

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

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities']*

Objective

The objective of this Standard is to prescribe the classification and disclosure of certain items in the statement of profit and loss so that all enterprises prepare and present such a statement on a uniform basis. This enhances the comparability of the financial statements of an enterprise over time and with the financial statements of other enterprises. Accordingly, this Standard requires the classification and disclosure of extraordinary and prior period items, and the disclosure of certain items within profit or loss from ordinary activities. It also specifies the accounting treatment for changes in accounting estimates and the disclosures to be made in the financial statements regarding changes in accounting policies.

Scope

1. This Standard should be applied by an enterprise in presenting profit or loss from ordinary activities, extraordinary items and prior period items in the statement of profit and loss, in accounting for changes in accounting estimates, and in disclosure of changes in accounting policies.

2. This Standard deals with, among other matters, the disclosure of certain items of net profit or loss for the period. These disclosures are made in addition to any other disclosures required by other Accounting Standards.

3. This Standard does not deal with the tax implications of extraordinary items, prior period items, changes in accounting estimates, and changes in accounting policies for which appropriate adjustments will have to be made depending on the circumstances.

Definitions

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

4.1. Ordinary activities are any activities which are undertaken by an enterprise as part of its business and such related activities in which the enterprise engages in furtherance of, incidental to, or arising from, these activities.

4.2. Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly.

4.3. Prior period items are income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods.

---

* Revised in 1997. A limited revision was made in 2001, pursuant to which paragraph 33 has been added in this standard (see footnote 2).

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

4.4. <u>Accounting policies</u> are the specific accounting principles and the methods of applying those principles adopted by an enterprise in the preparation and presentation of financial statements.

Net Profit or Loss for the Period

5. All items of income and expense which are recognised in a period should be included in the determination of net profit or loss for the period unless an Accounting Standard requires or permits otherwise.

6. Normally, all items of income and expense which are recognised in a period are included in the determination of the net profit or loss for the period. This includes extraordinary items and the effects of changes in accounting estimates.

7. The net profit or loss for the period comprises the following components, each of which should be disclosed on the face of the statement of profit and loss:

(a) profit or loss from ordinary activities; and

(b) extraordinary items.

Extraordinary Items

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

9. Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item.

10. Whether an event or transaction is clearly distinct from the ordinary activities of the enterprise is determined by the nature of the event or transaction in relation to the business ordinarily carried on by the enterprise rather than by the frequency with which such events are expected to occur. Therefore, an event or transaction may be extraordinary for one enterprise but not so for another enterprise because of the differences between their respective ordinary activities. For example, losses sustained as a result of an earthquake may qualify as an extraordinary item for many enterprises. However, claims from policyholders arising from an earthquake do not qualify as an extraordinary item for an insurance enterprise that insures against such risks.

11. Examples of events or transactions that generally give rise to extraordinary items for most enterprises are:

- attachment of property of the enterprise; or
- an earthquake.

Profit or Loss from Ordinary Activities

12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.

13. Although the items of income and expense described in paragraph 12 are not extraordinary items, the nature and amount of such items may be relevant to users of financial statements in understanding the financial position and performance of an enterprise and in making projections about financial

position and performance. Disclosure of such information is sometimes made in the notes to the financial statements.

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

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

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

(c) disposals of items of fixed assets;

(d) disposals of long-term investments;

(e) legislative changes having retrospective application;

(f) litigation settlements; and

(g) other reversals of provisions.

Prior Period Items

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

16. The term 'prior period items', as defined in this Standard , refers only to income or expenses which arise in the current period as a result of errors or omissions in the preparation of the financial statements of one or more prior periods. The term does not include other adjustments necessitated by circumstances, which though related to prior periods, are determined in the current period, e.g., arrears payable to workers as a result of revision of wages with retrospective effect during the current period.

17. Errors in the preparation of the financial statements of one or more prior periods may be discovered in the current period. Errors may occur as a result of mathematical mistakes, mistakes in applying accounting policies, misinterpretation of facts, or oversight.

18. Prior period items are generally infrequent in nature and can be distinguished from changes in accounting estimates. Accounting estimates by their nature are approximations that may need revision as additional information becomes known. For example, income or expense recognised on the outcome of a contingency which previously could not be estimated reliably does not constitute a prior period item.

19. Prior period items are normally included in the determination of net profit or loss for the current period. An alternative approach is to show such items in the statement of profit and loss after determination of current net profit or loss. In either case, the objective is to indicate the effect of such items on the current profit or loss.

Changes in Accounting Estimates

20. As a result of the uncertainties inherent in business activities, many financial statement items cannot be measured with precision but can only be estimated. The estimation process involves judgments based on the latest information available. Estimates may be required, for example, of bad debts, inventory obsolescence or the useful lives of depreciable assets. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

21. An estimate may have to be revised if changes occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience or subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definitions of an extraordinary item or a prior period item.

22. Sometimes, it is difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In such cases, the change is treated as a change in an accounting estimate, with appropriate disclosure.

23. The effect of a change in an accounting estimate should be included in the determination of net profit or loss in:

- ***(a) the period of the change, if the change affects the period only; or***
- ***(b) the period of the change and future periods, if the change affects both.***

24. A change in an accounting estimate may affect the current period only or both the current period and future periods. For example, a change in the estimate of the amount of bad debts is recognised immediately and therefore affects only the current period. However, a change in the estimated useful life of a depreciable asset affects the depreciation in the current period and in each period during the remaining useful life of the asset. In both cases, the effect of the change relating to the current period is recognised as income or expense in the current period. The effect, if any, on future periods, is recognised in future periods.

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

26. To ensure the comparability of financial statements of different periods, the effect of a change in an accounting estimate which was previously included in the profit or loss from ordinary activities is included in that component of net profit or loss. The effect of a change in an accounting estimate that was previously included as an extraordinary item is reported as an extraordinary item.

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

Changes in Accounting Policies

28. Users need to be able to compare the financial statements of an enterprise over a period of time in order to identify trends in its financial position, performance and cash flows. Therefore, the same accounting policies are normally adopted for similar events or transactions in each period.

29. A change in an accounting policy should be made only if the adoption of a different accounting policy is required by statute or for compliance with an accounting standard or if it is considered that the change would result in a more appropriate presentation of the financial statements of the enterprise.

30. A more appropriate presentation of events or transactions in the financial statements occurs when the new accounting policy results in more relevant or reliable information about the financial position, performance or cash flows of the enterprise.

31. The following are not changes in accounting policies :

- (a) the adoption of an accounting policy for events or transactions that differ in substance from previously occurring events or transactions, e.g., introduction of a formal retirement gratuity scheme by an employer in place of ad hoc ex-gratia payments to employees on retirement; and

(b) the adoption of a new accounting policy for events or transactions which did not occur previously or that were immaterial.

32. Any change in an accounting policy which has a material effect should be disclosed. The impact of, and the adjustments resulting from, such change, if material, should be shown in the financial statements of the period in which such change is made, to reflect the effect of such change. Where the effect of such change is not ascertainable, wholly or in part, the fact should be indicated. If a change is made in the accounting policies which has no material effect on the financial statements for the current period but which is reasonably expected to have a material effect in later periods, the fact of such change should be appropriately disclosed in the period in which the change is adopted.

33. A change in accounting policy consequent upon the adoption of an Accounting Standard should be accounted for in accordance with the specific transitional provisions, if any, contained in that Accounting Standard. However, disclosures required by paragraph 32 of this Standard should be made unless the transitional provisions of any other Accounting Standard require alternative disclosures in this regard.[2]

AS 11*: The Effects of Changes in Foreign Exchange Rates

*[This Accounting Standard includes paragraphs set in bold italic type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards*1 *and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

An enterprise may carry on activities involving foreign exchange in two ways. It may have transactions in foreign currencies or it may have foreign operations. In order to include foreign currency transactions and foreign operations in the financial statements of an enterprise, transactions must be expressed in the enterprise's reporting currency and the financial statements of foreign operations must be translated into the enterprise's reporting currency.

The principal issues in accounting for foreign currency transactions and foreign operations are to decide which exchange rate to use and how to recognise in the financial statements the financial effect of changes in exchange rates.

Scope

1. This Standard should be applied:

(a) in accounting for transactions in foreign currencies; and

---

[2] As a limited revision to AS 5, the Council of the Institute decided to add this paragraph in AS 5 in 2001. This revision came into effect in respect of accounting periods commencing on or after 1.4.2001 (see 'The Chartered Accountant', September 2001, pp. 342).

* Originally issued in 1989 and revised in 1994. The standard was revised again in 2003 and came into effect in respect of accounting periods commencing on or after 1-4-2004 and is mandatory in nature from that date. The revised Standard supersedes Accounting Standard (AS) 11, Accounting for the Effects of Changes in Foreign Exchange Rates (1994), except that in respect of accounting for transactions in foreign currencies entered into by the reporting enterprise itself or through its branches before the date this Standard comes into effect, AS 11 (1994) will continue to be applicable.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

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

2. This Standard also deals with accounting for foreign currency transactions in the nature of forward exchange contracts.[2]

3. This Standard does not specify the currency in which an enterprise presents its financial statements. However, an enterprise normally uses the currency of the country in which it is domiciled. If it uses a different currency, this Standard requires disclosure of the reason for using that currency. This Standard also requires disclosure of the reason for any change in the reporting currency.

4. This Standard does not deal with the restatement of an enterprise's financial statements from its reporting currency into another currency for the convenience of users accustomed to that currency or for similar purposes.

5. This Standard does not deal with the presentation in a cash flow statement of cash flows arising from transactions in a foreign currency and the translation of cash flows of a foreign operation (see AS 3, Cash Flow Statements).

6. This Standard does not deal with exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs (see paragraph 4(e) of AS 16, Borrowing Costs).

Definitions

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

7.1 <u>Average rate</u> is the mean of the exchange rates in force during a period.

7.2 <u>Closing rate</u> is the exchange rate at the balance sheet date.

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

7.4 <u>Exchange rate</u> is the ratio for exchange of two currencies.

7.5 <u>Fair value</u> is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

7.6 <u>Foreign currency</u> is a currency other than the reporting currency of an enterprise.

7.7 <u>Foreign operation</u> is a subsidiary[3], associate[4], joint venture[5] or branch of the reporting enterprise, the activities of which are based or conducted in a country other than the country of the reporting enterprise.

7.8 <u>Forward exchange contract</u> means an agreement to exchange different currencies at a forward rate.

---

[2] This Standard is applicable to exchange differences on all forward exchange contracts including those entered into to hedge the foreign currency risk of existing assets and liabilities and is not applicable to exchange difference arising on forward exchange contracts entered into to hedge the foreign currency risk of future transactions in respect of which a firm commitments are made or which are highly probable forecast transactions. A 'firm commitment' is a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates and a 'forecast transaction' is an uncommitted but anticipated future transaction.

[3] As defined in AS 21, Consolidated Financial Statements.

[4] As defined in AS 23, Accounting for Investments in Associates in Consolidated Financial Statements.

[5] As defined in AS 27, Financial Reporting of Interests in Joint Ventures.

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

7.10 Integral foreign operation is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.

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

7.12 Net investment in a non-integral foreign operation is the reporting enterprise's share in the net assets of that operation.

7.13 Non-integral foreign operation is a foreign operation that is not an integral foreign operation.

7.14 Non-monetary items are assets and liabilities other than monetary items.

7.15 Reporting currency is the currency used in presenting the financial statements.

Foreign Currency Transactions

Initial Recognition

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

(a) buys or sells goods or services whose price is denominated in a foreign currency;

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

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

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

9. A foreign currency transaction should be recorded, on initial recognition in the reporting currency, by applying to the foreign currency amount the exchange rate between the reporting currency and the foreign currency at the date of the transaction.

10. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Reporting at Subsequent Balance Sheet Dates

11. At each balance sheet date:

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

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

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

12. Cash, receivables, and payables are examples of monetary items. Fixed assets, inventories, and investments in equity shares are examples of non-monetary items. The carrying amount of an item is determined in accordance with the relevant Accounting Standards. For example, certain assets may be measured at fair value or other similar valuation (e.g., net realisable value) or at historical cost. Whether the carrying amount is determined based on fair value or other similar valuation or at historical cost, the amounts so determined for foreign currency items are then reported in the reporting currency in accordance with this Standard. The contingent liability denominated in foreign currency at the balance sheet date is disclosed by using the closing rate.

Recognition of Exchange Differences

13. Exchange differences arising on the settlement of monetary items or on reporting an enterprise's monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognised as income or as expenses in the period in which they arise, with the exception of exchange differences dealt with in accordance with paragraph 15.

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

Net Investment in a Non-integral Foreign Operation

15. Exchange differences arising on a monetary item that, in substance, forms part of an enterprise's net investment in a non-integral foreign operation should be accumulated in a foreign currency translation reserve in the enterprise's financial statements until the disposal of the net investment, at which time they should be recognised as income or as expenses in accordance with paragraph 31.

16. An enterprise may have a monetary item that is receivable from, or payable to, a non-integral foreign operation. An item for which settlement is neither planned nor likely to occur in the foreseeable future is, in substance, an extension to, or deduction from, the enterprise's net investment in that non-integral foreign operation. Such monetary items may include long-term receivables or loans but do not include trade receivables or trade payables.

Financial Statements of Foreign Operations

Classification of Foreign Operations

17. The method used to translate the financial statements of a foreign operation depends on the way in which it is financed and operates in relation to the reporting enterprise. For this purpose, foreign operations are classified as either "integral foreign operations" or "non-integral foreign operations".

18. A foreign operation that is integral to the operations of the reporting enterprise carries on its business as if it were an extension of the reporting enterprise's operations. For example, such a foreign operation might only sell goods imported from the reporting enterprise and remit the proceeds to the reporting enterprise. In such cases, a change in the exchange rate between the reporting currency and the currency in the country of foreign operation has an almost immediate effect on the reporting enterprise's cash flow from operations. Therefore, the change in the exchange rate affects the individual monetary items held by the foreign operation rather than the reporting enterprise's net investment in that operation.

19. In contrast, a non-integral foreign operation accumulates cash and other monetary items, incurs expenses, generates income and perhaps arranges borrowings, all substantially in its local currency. It may also enter into transactions in foreign currencies, including transactions in the reporting currency. When there is a change in the exchange rate between the reporting currency and the local currency, there is little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. The change in the exchange rate affects the reporting enterprise's net investment in the non-integral foreign operation rather than the individual monetary and non-monetary items held by the non-integral foreign operation.

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

(a) while the reporting enterprise may control the foreign operation, the activities of the foreign operation are carried out with a significant degree of autonomy from those of the reporting enterprise;

(b) transactions with the reporting enterprise are not a high proportion of the foreign operation's activities;

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

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

(e) the foreign operation's sales are mainly in currencies other than the reporting currency;

(f) cash flows of the reporting enterprise are insulated from the day-to-day activities of the foreign operation rather than being directly affected by the activities of the foreign operation;

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

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

The appropriate classification for each operation can, in principle, be established from factual information related to the indicators listed above. In some cases, the classification of a foreign operation as either a non- integral foreign operation or an integral foreign operation of the reporting enterprise may not be clear, and judgement is necessary to determine the appropriate classification.

Integral Foreign Operations

21. The financial statements of an integral foreign operation should be translated using the principles and procedures in paragraphs 8 to 16 as if the transactions of the foreign operation had been those of the reporting enterprise itself.

22. The individual items in the financial statements of the foreign operation are translated as if all its transactions had been entered into by the reporting enterprise itself. The cost and depreciation of tangible fixed assets is translated using the exchange rate at the date of purchase of the asset or, if the asset is carried at fair value or other similar valuation, using the rate that existed on the date of the valuation. The cost of inventories is translated at the exchange rates that existed when those costs were incurred. The recoverable amount or realisable value of an asset is translated using the exchange rate that existed when the recoverable amount or net realisable value was determined. For example, when the net realisable value of an item of inventory is determined in a foreign currency, that value is translated using the exchange rate at the date as at which the net realisable value is determined. The rate used is therefore usually the closing rate. An adjustment may be required to reduce the carrying amount of an asset in the financial statements of the reporting enterprise to its recoverable amount or net realisable value even when no such adjustment is necessary in the financial statements of the foreign operation. Alternatively, an adjustment in the financial statements of the foreign operation may need to be reversed in the financial statements of the reporting enterprise.

23. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is unreliable.

Non-integral Foreign Operations

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

- ***(a) the assets and liabilities, both monetary and non-monetary, of the non-integral foreign operation should be translated at the closing rate;***
- ***(b) income and expense items of the non-integral foreign operation should be translated at exchange rates at the dates of the transactions; and***
- ***(c) all resulting exchange differences should be accumulated in a foreign currency translation reserve until the disposal of the net investment.***

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

26. The translation of the financial statements of a non-integral foreign operation results in the recognition of exchange differences arising from:

- (a) translating income and expense items at the exchange rates at the dates of transactions and assets and liabilities at the closing rate;
- (b) translating the opening net investment in the non-integral foreign operation at an exchange rate different from that at which it was previously reported; and
- (c) other changes to equity in the non-integral foreign operation. These exchange differences are not recognised as income or expenses for the period because the changes in the exchange rates have little or no direct effect on the present and future cash flows from operations of either the non-integral foreign operation or the reporting enterprise. When a

non- integral foreign operation is consolidated but is not wholly owned, accumulated exchange differences arising from translation and attributable to minority interests are allocated to, and reported as part of, the minority interest in the consolidated balance sheet.

27. Any goodwill or capital reserve arising on the acquisition of a non- integral foreign operation is translated at the closing rate in accordance with paragraph 24.

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

29. The incorporation of the financial statements of a non-integral foreign operation in those of the reporting enterprise follows normal consolidation procedures, such as the elimination of intra-group balances and intra- group transactions of a subsidiary (see AS 21, Consolidated Financial Statements, and AS 27, Financial Reporting of Interests in Joint Ventures). However, an exchange difference arising on an intra-group monetary item, whether short-term or long-term, cannot be eliminated against a corresponding amount arising on other intra-group balances because the monetary item represents a commitment to convert one currency into another and exposes the reporting enterprise to a gain or loss through currency fluctuations. Accordingly, in the consolidated financial statements of the reporting enterprise, such an exchange difference continues to be recognised as income or an expense or, if it arises from the circumstances described in paragraph 15, it is accumulated in a foreign currency translation reserve until the disposal of the net investment.

30. When the financial statements of a non-integral foreign operation are drawn up to a different reporting date from that of the reporting enterprise, the non-integral foreign operation often prepares, for purposes of incorporation in the financial statements of the reporting enterprise, statements as at the same date as the reporting enterprise. When it is impracticable to do this, AS 21, Consolidated Financial Statements, allows the use of financial statements drawn up to a different reporting date provided that the difference is no greater than six months and adjustments are made for the effects of any significant transactions or other events that occur between the different reporting dates. In such a case, the assets and liabilities of the non-integral foreign operation are translated at the exchange rate at the balance sheet date of the non-integral foreign operation and adjustments are made when appropriate for significant movements in exchange rates up to the balance sheet date of the reporting enterprises in accordance with AS 21. The same approach is used in applying the equity method to associates and in applying proportionate consolidation to joint ventures in accordance with AS 23, Accounting for Investments in Associates in Consolidated Financial Statements and AS 27, Financial Reporting of Interests in Joint Ventures.

Disposal of a Non-integral Foreign Operation

31. On the disposal of a non-integral foreign operation, the cumulative amount of the exchange differences which have been deferred and which relate to that operation should be recognised as income or as expenses in the same period in which the gain or loss on disposal is recognised.

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

Change in the Classification of a Foreign Operation

33. When there is a change in the classification of a foreign operation, the translation procedures applicable to the revised classification should be applied from the date of the change in the classification.

34. The consistency principle requires that foreign operation once classified as integral or non-integral is continued to be so classified. However, a change in the way in which a foreign operation is financed and operates in relation to the reporting enterprise may lead to a change in the classification of that foreign operation. When a foreign operation that is integral to the operations of the reporting enterprise is reclassified as a non-integral foreign operation, exchange differences arising on the translation of non-monetary assets at the date of the reclassification are accumulated in a foreign currency translation reserve. When a non-integral foreign operation is reclassified as an integral foreign operation, the translated amounts for non-monetary items at the date of the change are treated as the historical cost for those items in the period of change and subsequent periods. Exchange differences which have been deferred are not recognised as income or expenses until the disposal of the operation.

All Changes in Foreign Exchange Rates

Tax Effects of Exchange Differences

35. Gains and losses on foreign currency transactions and exchange differences arising on the translation of the financial statements of foreign operations may have associated tax effects which are accounted for in accordance with AS 22, Accounting for Taxes on Income.

Forward Exchange Contracts[6]

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

37. The risks associated with changes in exchange rates may be mitigated by entering into forward exchange contracts. Any premium or discount arising at the inception of a forward exchange contract is accounted for separately from the exchange differences on the forward exchange contract. The premium or discount that arises on entering into the contract is measured by the difference between the exchange rate at the date of the inception of the forward exchange contract and the forward rate specified in the contract. Exchange difference on a forward exchange contract is the difference between (a) the foreign currency amount of the contract translated at the exchange rate at the reporting date, or the settlement date where the transaction is settled during the reporting period, and (b) the same foreign currency amount translated at the latter of the date of inception of the forward exchange contract and the last reporting date.

---

[6] See footnote 2.

38. A gain or loss on a forward exchange contract to which paragraph 36 does not apply should be computed by multiplying the foreign currency amount of the forward exchange contract by the difference between the forward rate available at the reporting date for the remaining maturity of the contract and the contracted forward rate (or the forward rate last used to measure a gain or loss on that contract for an earlier period). The gain or loss so computed should be recognised in the statement of profit and loss for the period. The premium or discount on the forward exchange contract is not recognised separately.

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

Disclosure

40. An enterprise should disclose:

- ***(a) the amount of exchange differences included in the net profit or loss for the period; and***
- ***(b) net exchange differences accumulated in foreign currency translation reserve as a separate component of shareholders' funds, and a reconciliation of the amount of such exchange differences at the beginning and end of the period.***

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

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

- ***(a) the nature of the change in classification;***
- ***(b) the reason for the change;***
- ***(c) the impact of the change in classification on shareholders' funds; and***
- ***(d) the impact on net profit or loss for each prior period presented had the change in classification occurred at the beginning of the earliest period presented.***

43. The effect on foreign currency monetary items or on the financial statements of a foreign operation of a change in exchange rates occurring after the balance sheet date is disclosed in accordance with AS 4, Contingencies and Events Occurring After the Balance Sheet Date.

44. Disclosure is also encouraged of an enterprise's foreign currency risk management policy.

Transitional Provisions

45. On the first time application of this Standard, if a foreign branch is classified as a non-integral foreign operation in accordance with the requirements of this Standard, the accounting treatment prescribed in paragraphs 33 and 34 of the Standard in respect of change in the classification of a foreign operation should be applied.

46[7] In respect of accounting periods commencing on or after 7th December, 2006 and ending on or before 31st March, 2011,[8] at the option of the enterprise (such option to be irrevocable and to be excercised retrospectively for such accounting period, from the date this transitional provision comes into force or the first date on which the concerned foreign currency monetary item is acquired, whichever is later, and applied to all such foreign currency monetary items), exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset/ liability but not beyond 31st March, 2011, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with paragraph 15. For the purposes of exercise of this option, an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of 12 months or more at the date of origination of the asset or liability. Any difference pertaining to accounting periods which commenced on or after 7th December, 2006, previously recognized in the profit and loss account before the exercise of the option shall be reversed in so far as it relates to the acquisition of a depreciable capital asset by addition or deduction from the cost of the asset and in other cases by transfer to "Foreign Currency Monetary Item Translation Difference Account" in both cases, by debit or credit, as the case may be, to the general reserve. If the option stated in this paragraph is exercised, disclosure shall be made of the fact of such exercise of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

46A.[9] (1) In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long- term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset, and in other cases, can be accumulated in a ''Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15 of the said rules.

---

[7] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 31st March, 2009, which is relevant for companies. Necessary process is being followed to make this paragraph with subsequent modifications indicated in footnote 8 below applicable to non-corporate entities also.

[8] 31st March, 2011" was substituted by "31st March, 2012" by Notification dated 11th May, 2011, published by Ministry of Corporate Affairs, Government of India. Thereafter, "31st March, 2012" was substituted by "31st March, 2020" by Notification dated 29th December, 2011, published by Ministry of Corporate Affairs, Government of India.

[9] Ministry of Corporate Affairs, Government of India, inserted this paragraph by Notification dated 29th December, 2011, which is relevant for companies. Necessary process is being followed to make this paragraph applicable to non-corporate entities also.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise shall disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Paragraphs 46 for entities other than Companies

46 (1) In respect of accounting periods commencing on or after 7th December, 2006 (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long-term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and should be depreciated over the balance life of the asset, and in other cases, can be accumulated in a "Foreign Currency Monetary Item Translation Difference Account" in the enterprise's financial statements and amortized over the balance period of such long-term asset or liability, by recognition as income or expense in each of such periods, with the exception of exchange differences dealt with in accordance with the provisions of paragraph 15.

(2) To exercise the option referred to in sub-paragraph (1), an asset or liability shall be designated as a long-term foreign currency monetary item, if the asset or liability is expressed in a foreign currency and has a term of twelve months or more at the date of origination of the asset or the liability:

Provided that the option exercised by the enterprise should disclose the fact of such option and of the amount remaining to be amortized in the financial statements of the period in which such option is exercised and in every subsequent period so long as any exchange difference remains unamortized."

Clarification on Para 46A of notification number G.S.R. 914(E) dated 29.12.2011 on Accounting Standard 11 relating to "The effects of Changes in Foreign Exchange Rates"

The Ministry has received several representations from industry associations that Para 6 of AS 11 and Para 4(e) of AS 16 are posing problems in proper implementation of Para 46A of AS 11 inserted vide notification 914(E) dated 29.12.2011. In order to resolve the problems faced by industry, MCA had further clarified vide Circular No. 25/2012 dated 09.08.2012 that Para 6 of AS 11 and Para 4(e) of the AS 16 shall not apply to a company which is applying clause Para 46A of AS 11.

Announcement

Presentation of Foreign Currency Monetary Item Translation Difference Account

In the Revised Schedule VI format, no line item has been specified for the presentation of "Foreign Currency Monetary Item Translation Difference Account (FCMITDA)" (See 'NOTE' below). Therefore, the Council of the Institute at its 324th meeting held on March 24-26, 2013 at New Delhi, considered the issue regarding the presentation of the FCMITDA in the balance sheet. The Council considered the *definition of an asset given in the Framework on Preparation and Presentation of Financial Statements issued by ICAI which states as follows:*

"An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise."

Since the balance in FCMITDA represents foreign currency translation loss, it does not meet the above definition of 'asset' as it is neither a resource nor any future economic benefit would flow to the entity therefrom. Therefore, such balance cannot be reflected as an asset. Accordingly, the Council decided that debit or credit balance in FCMITDA should be shown on the "Equity and Liabilities" side of the balance sheet under the head 'Reserves and Surplus' as a separate line item.

AS 12* – Accounting for Government Grants

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Introduction

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

2. This Standard does not deal with:

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

   (ii) government assistance other than in the form of government grants;

   (iii) government participation in the ownership of the enterprise.

Definitions

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

3.1 Government refers to government, government agencies and similar bodies whether local, national or international.

3.2 Government grants are assistance by government in cash or kind to an enterprise for past or future compliance with certain conditions. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the enterprise.

Explanation

4. The receipt of government grants by an enterprise is significant for preparation of the financial statements for two reasons. Firstly, if a government grant has been received, an appropriate method of accounting therefor is necessary. Secondly, it is desirable to give an indication of the extent to which

---

* issued in 1991

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

the enterprise has benefited from such grant during the reporting period. This facilitates comparison of an enterprise's financial statements with those of prior periods and with those of other enterprises.

Accounting Treatment of Government Grants

5. Capital Approach versus Income Approach

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

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

(i) Many government grants are in the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay and no repayment is ordinarily expected in the case of such grants. These should, therefore, be credited directly to shareholders' funds.

(ii) It is inappropriate to recognise government grants in the profit and loss statement, since they are not earned but represent an incentive provided by government without related costs.

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

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

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

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

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

5.5 It is fundamental to the 'income approach' that government grants be recognised in the profit and loss statement on a systematic and rational basis over the periods necessary to match them with the related costs. Income recognition of government grants on a receipts basis is not in accordance with the accrual accounting assumption (see Accounting Standard (AS) 1, Disclosure of Accounting Policies).

5.6 In most cases, the periods over which an enterprise recognises the costs or expenses related to a government grant are readily ascertainable and thus grants in recognition of specific expenses are taken to income in the same period as the relevant expenses.

6. Recognition of Government Grants

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

(i) where there is reasonable assurance that the enterprise will comply with the conditions attached to them; and

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

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

6.2 An appropriate amount in respect of such earned benefits, estimated on a prudent basis, is credited to income for the year even though the actual amount of such benefits may be finally settled and received after the end of the relevant accounting period.

6.3 A contingency related to a government grant, arising after the grant has been recognised, is treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[2]

6.4 In certain circumstances, a government grant is awarded for the purpose of giving immediate financial support to an enterprise rather than as an incentive to undertake specific expenditure. Such grants may be confined to an individual enterprise and may not be available to a whole class of enterprises. These circumstances may warrant taking the grant to income in the period in which the enterprise qualifies to receive it, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

6.5 Government grants may become receivable by an enterprise as compensation for expenses or losses incurred in a previous accounting period. Such a grant is recognised in the income statement of the period in which it becomes receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

7. Non-monetary Government Grants

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

8. Presentation of Grants Related to Specific Fixed Assets

8.1 Grants related to specific fixed assets are government grants whose primary condition is that an enterprise qualifying for them should purchase, construct or otherwise acquire such assets. Other conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

8.2 Two methods of presentation in financial statements of grants (or the appropriate portions of grants) related to specific fixed assets are regarded as acceptable alternatives.

8.3 Under one method, the grant is shown as a deduction from the gross value of the asset concerned in arriving at its book value. The grant is thus recognised in the profit and loss statement over the useful life of a depreciable asset by way of a reduced depreciation charge. Where the grant equals the whole, or virtually the whole, of the cost of the asset, the asset is shown in the balance sheet at a nominal value.

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

---

[2] Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

life of the asset. Such allocation to income is usually made over the periods and in the proportions in which depreciation on related assets is charged. Grants related to non-depreciable assets are credited to capital reserve under this method, as there is usually no charge to income in respect of such assets. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant is credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income is suitably disclosed in the balance sheet pending its apportionment to profit and loss account. For example, in the case of a company, it is shown after 'Reserves and Surplus' but before 'Secured Loans' with a suitable description, e.g., 'Deferred government grants'.

8.5 The purchase of assets and the receipt of related grants can cause major movements in the cash flow of an enterprise. For this reason and in order to show the gross investment in assets, such movements are often disclosed as separate items in the statement of changes in financial position regardless of whether or not the grant is deducted from the related asset for the purpose of balance sheet presentation.

9. Presentation of Grants Related to Revenue

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

9.2 Supporters of the first method claim that it is inappropriate to net income and expense items and that separation of the grant from the expense facilitates comparison with other expenses not affected by a grant. For the second method, it is argued that the expense might well not have been incurred by the enterprise if the grant had not been available and presentation of the expense without offsetting the grant may therefore be misleading.

10. Presentation of Grants of the nature of Promoters' contribution

10.1 Where the government grants are of the nature of promoters' contribution, i.e., they are given with reference to the total investment in an undertaking or by way of contribution towards its total capital outlay (for example, central investment subsidy scheme) and no repayment is ordinarily expected in respect thereof, the grants are treated as capital reserve which can be neither distributed as dividend nor considered as deferred income.

11. Refund of Government Grants

11.1 Government grants sometimes become refundable because certain conditions are not fulfilled. A government grant that becomes refundable is treated as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

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

11.3 The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value is provided prospectively over the residual useful life of the asset.

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

12. Disclosure

12.1 The following disclosures are appropriate:

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

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

Main Principles

13. Government grants should not be recognised until there is reasonable assurance that (i) the enterprise will comply with the conditions attached to them, and (ii) the grants will be received.

14. Government grants related to specific fixed assets should be presented in the balance sheet by showing the grant as a deduction from the gross value of the assets concerned in arriving at their book value. Where the grant related to a specific fixed asset equals the whole, or virtually the whole, of the cost of the asset, the asset should be shown in the balance sheet at a nominal value. Alternatively, government grants related to depreciable fixed assets may be treated as deferred income which should be recognised in the profit and loss statement on a systematic and rational basis over the useful life of the asset, i.e., such grants should be allocated to income over the periods and in the proportions in which depreciation on those assets is charged. Grants related to non-depreciable assets should be credited to capital reserve under this method. However, if a grant related to a non-depreciable asset requires the fulfillment of certain obligations, the grant should be credited to income over the same period over which the cost of meeting such obligations is charged to income. The deferred income balance should be separately disclosed in the financial statements.

15. Government grants related to revenue should be recognised on a systematic basis in the profit and loss statement over the periods necessary to match them with the related costs which they are intended to compensate. Such grants should either be shown separately under 'other income' or deducted in reporting the related expense.

16. Government grants of the nature of promoters' contribution should be credited to capital reserve and treated as a part of shareholders' funds.

17. Government grants in the form of non-monetary assets, given at a concessional rate, should be accounted for on the basis of their acquisition cost. In case a non-monetary asset is given free of cost, it should be recorded at a nominal value.

18. Government grants that are receivable as compensation for expenses or losses incurred in a previous accounting period or for the purpose of giving immediate financial support to the enterprise with no further related costs, should be recognised and disclosed in the profit and loss statement of the period in which they are receivable, as an extraordinary item if appropriate (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

19. A contingency related to a government grant, arising after the grant has been recognised, should be treated in accordance with Accounting Standard (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date.[3]

20. Government grants that become refundable should be accounted for as an extraordinary item (see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).

21. The amount refundable in respect of a grant related to revenue should be applied first against any unamortised deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount should be charged to profit and loss statement. The amount refundable in respect of a grant related to a specific fixed asset should be recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. In the first alternative, i.e., where the book value of the asset is increased, depreciation on the revised book value should be provided prospectively over the residual useful life of the asset.

22. Government grants in the nature of promoters' contribution that become refundable should be reduced from the capital reserve.

Disclosure

23. The following should be disclosed:

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

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

Exposure Draft on Limited Revision of AS 12 has recently been issued by ICAI to synchronize the presentation requirements of AS 12, Accounting for Government Grants, with the presentation requirements prescribed under revised Schedule VI to the Companies Act, 1956 (Now Schedule III to the Companies Act, 2013). The additional disclosure requirement for deferred grant has been proposed by this Exposure Draft. As the amounts deferred bear the characteristics of unearned income and should be classified as liability, it is also proposed to amend paragraphs 12.1 and 23 of existing AS 12 to prescribe presentation of deferred government grants. It is pertinent to note that this Limited Revision has not yet been notified by the Govt. The Limited Revision will come into effect as and when it will be notified by the Govt.

AS 16[*] : Borrowing Costs

[This Accounting Standard includes paragraphs set in ***bold italic*** *type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should*

[3] See footnote 2.

[*] Issued in 2000.

be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] *and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

The objective of this Standard is to prescribe the accounting treatment for borrowing costs.

Scope

1. This Standard should be applied in accounting for borrowing costs.

2. This Standard does not deal with the actual or imputed cost of owners' equity, including preference share capital not classified as a liability.

Definitions

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

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

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

Explanation:

What constitutes a substantial period of time primarily depends on the facts and circumstances of each case. However, ordinarily, a period of twelve months is considered as substantial period of time unless a shorter or longer period can be justified on the basis of facts and circumstances of the case. In estimating the period, time which an asset takes, technologically and commercially, to get it ready for its intended use or sale is considered.

4. Borrowing costs may include:

(a) interest and commitment charges on bank borrowings and other short-term and long-term borrowings;

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

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

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

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

Explanation:

Exchange differences arising from foreign currency borrowing and considered as borrowing costs are those exchange differences which arise on the amount of principal of the foreign currency borrowings to the extent of the difference between interest on local currency borrowings and interest on foreign currency borrowings. Thus, the amount of exchange difference not exceeding the difference between interest on local currency borrowings and interest on foreign currency borrowings is considered as borrowings cost to be accounted for under this Standard and the remaining exchange difference, if any,

---

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

is accounted for under AS 11, The Effect of Changes in Foreign Exchange Rates. For this purpose, the interest rate for the local currency borrowings is considered as that rate at which the enterprise would have raised the borrowings locally had the enterprise not decided to raise the foreign currency borrowings.

The application of this explanation is illustrated in the Illustration attached to the Standard.

5. Examples of qualifying assets are manufacturing plants, power generation facilities, inventories that require a substantial period of time to bring them to a saleable condition, and investment properties. Other investments, and those inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time, are not qualifying assets. Assets that are ready for their intended use or sale when acquired also are not qualifying assets.

Recognition

6. Borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset should be capitalised as part of the cost of that asset. The amount of borrowing costs eligible for capitalisation should be determined in accordance with this Standard. Other borrowing costs should be recognised as an expense in the period in which they are incurred.

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

Borrowing Costs Eligible for Capitalisation

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

9. It may be difficult to identify a direct relationship between particular borrowings and a qualifying asset and to determine the borrowings that could otherwise have been avoided. Such a difficulty occurs, for example, when the financing activity of an enterprise is co-ordinated centrally or when a range of debt instruments are used to borrow funds at varying rates of interest and such borrowings are not readily identifiable with a specific qualifying asset. As a result, the determination of the amount of borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset is often difficult and the exercise of judgement is required.

10. To the extent that funds are borrowed specifically for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation on that asset should be determined as the actual borrowing costs incurred on that borrowing during the period less any income on the temporary investment of those borrowings.

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

12. To the extent that funds are borrowed generally and used for the purpose of obtaining a qualifying asset, the amount of borrowing costs eligible for capitalisation should be determined

by applying a capitalisation rate to the expenditure on that asset. The capitalisation rate should be the weighted average of the borrowing costs applicable to the borrowings of the enterprise that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs capitalised during a period should not exceed the amount of borrowing costs incurred during that period.

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

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

Commencement of Capitalisation

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

(a) expenditure for the acquisition, construction or production of a qualifying asset is being incurred;

(b) borrowing costs are being incurred; and

(c) activities that are necessary to prepare the asset for its intended use or sale are in progress.

15. Expenditure on a qualifying asset includes only such expenditure that has resulted in payments of cash, transfers of other assets or the assumption of interest-bearing liabilities. Expenditure is reduced by any progress payments received and grants received in connection with the asset (see Accounting Standard 12, Accounting for Government Grants). The average carrying amount of the asset during a period, including borrowing costs previously capitalised, is normally a reasonable approximation of the expenditure to which the capitalisation rate is applied in that period.

16. The activities necessary to prepare the asset for its intended use or sale encompass more than the physical construction of the asset. They include technical and administrative work prior to the commencement of physical construction, such as the activities associated with obtaining permits prior to the commencement of the physical construction. However, such activities exclude the holding of an asset when no production or development that changes the asset's condition is taking place. For example, borrowing costs incurred while land is under development are capitalised during the period in which activities related to the development are being undertaken. However, borrowing costs incurred while land acquired for building purposes is held without any associated development activity do not qualify for capitalisation.

Suspension of Capitalisation

17. Capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

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

continues during the extended period needed for inventories to mature or the extended period during which high water levels delay construction of a bridge, if such high water levels are common during the construction period in the geographic region involved.

Cessation of Capitalisation

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

20. An asset is normally ready for its intended use or sale when its physical construction or production is complete even though routine administrative work might still continue. If minor modifications, such as the decoration of a property to the user's specification, are all that are outstanding, this indicates that substantially all the activities are complete.

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

22. A business park comprising several buildings, each of which can be used individually, is an example of a qualifying asset for which each part is capable of being used while construction continues for the other parts. An example of a qualifying asset that needs to be complete before any part can be used is an industrial plant involving several processes which are carried out in sequence at different parts of the plant within the same site, such as a steel mill.

Disclosure

23. The financial statements should disclose:

- ***(a) the accounting policy adopted for borrowing costs; and***
- ***(b) the amount of borrowing costs capitalised during the period.***

Illustration

Note: This illustration does not form part of the Accounting Standard. Its purpose is to assist in clarifying the meaning of paragraph 4(e) of the Standard.

Facts:

XYZ Ltd. has taken a loan of USD 10,000 on April 1, 20X3, for a specific project at an interest rate of 5% p.a., payable annually. On April 1, 20X3, the exchange rate between the currencies was ₹ 45 per USD. The exchange rate, as at March 31, 20X4, is ₹ 48 per USD. The corresponding amount could have been borrowed by XYZ Ltd. in local currency at an interest rate of 11 per cent annum as on April 1, 20X3.

The following computation would be made to determine the amount of borrowing costs for the purposes of paragraph 4(e) of AS 16:

- (i) Interest for the period = USD 10,000 × 5% × ₹ 48/USD = ₹ 24,000.
- (ii) Increase in the liability towards the principal amount = USD 10,000 × (48–45) = ₹ 30,000.
- (iii) Interest that would have resulted if the loan was taken in Indian currency = USD 10,000 × 45 × 11% = ₹ 49,500.
- (iv) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 49,500 – ₹ 24,000 = ₹ 25,500.

Therefore, out of ₹ 30,000 increase in the liability towards principal amount, only ₹ 25,500 will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 49,500 being the aggregate of interest of ₹ 24,000 on foreign currency borrowings [covered by paragraph 4(a) of AS 16] plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 25,500. Thus, ₹ 49,500 would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 4,500 would be considered as the exchange difference to be accounted for as per Accounting Standard (AS) 11, The Effects of Changes in Foreign Exchange Rates.

In the above example, if the interest rate on local currency borrowings is assumed to be 13% instead of 11%, the entire exchange difference of ₹ 30,000 would be considered as borrowing costs, since in that case the difference between the interest on local currency borrowings and foreign currency borrowings [i.e. ₹ 34,500 (₹ 58,500 – ₹ 24,000)] is more than the exchange difference of ₹ 30,000. Therefore, in such a case, the total borrowing cost would be ₹ 54,000 (₹ 24,000 + ₹ 30,000) which would be accounted for under AS 16 and there would be no exchange difference to be accounted for under AS 11, The Effects of Changes in Foreign Exchange Rates.

AS 19[1]: Leases

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

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

Scope

1. This Standard should be applied in accounting for all leases other than:

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

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

(c) lease agreements to use lands.

2. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

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

---

1 Issued in 2001

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

3.1 A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.

3.2 A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset.

3.3 An operating lease is a lease other than a finance lease.

3.4 A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency; or

(b) with the permission of the lessor; or

(c) if the lessee enters into a new lease for the same or an equivalent asset with the same lessor; or

(d) upon payment by the lessee of an additional amount such that, at inception, continuation of the lease is reasonably certain.

3.5 The inception of the lease is the earlier of the date of the lease agreement and the date of a commitment by the parties to the principal provisions of the lease.

3.6 The lease term is the non-cancellable period for which the lessee has agreed to take on lease the asset together with any further periods for which the lessee has the option to continue the lease of the asset, with or without further payment, which option at the inception of the lease it is reasonably certain that the lessee will exercise.

3.7 Minimum lease payments are the payments over the lease term that the lessee is, or can be required, to make excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with:

(a) in the case of the lessee, any residual value guaranteed by or on behalf of the lessee; or

(b) in the case of the lessor, any residual value guaranteed to the lessor:

(i) by or on behalf of the lessee; or

(ii) by an independent third party financially capable of meeting this guarantee.

However, if the lessee has an option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, is reasonably certain to be exercised, the minimum lease payments comprise minimum payments payable over the lease term and the payment required to exercise this purchase option.

3.8 Fair value is the amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction.

3.9 Economic life is either:

(a) the period over which an asset is expected to be economically usable by one or more users; or

(b) the number of production or similar units expected to be obtained from the asset by one or more users.

3.10 Useful life of a leased asset is either:

(a) the period over which the leased asset is expected to be used by the lessee; or

(b) the number of production or similar units expected to be obtained from the use of the asset by the lessee.

3.11 Residual value of a leased asset is the estimated fair value of the asset at the end of the lease term.

3.12 Guaranteed residual value is:

(a) in the case of the lessee, that part of the residual value which is guaranteed by the lessee or by a party on behalf of the lessee (the amount of the guarantee being the maximum amount that could, in any event, become payable); and

(b) in the case of the lessor, that part of the residual value which is guaranteed by or on behalf of the lessee, or by an independent third party who is financially capable of discharging the obligations under the guarantee.

3.13 Unguaranteed residual value of a leased asset is the amount by which the residual value of the asset exceeds its guaranteed residual value.

3.14 Gross investment in the lease is the aggregate of the minimum lease payments under a finance lease from the standpoint of the lessor and any unguaranteed residual value accruing to the lessor.

3.15 Unearned finance income is the difference between:

(a) the gross investment in the lease; and

(b) the present value of

(i) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(ii) any unguaranteed residual value accruing to the lessor, at the interest rate implicit in the lease.

3.16 Net investment in the lease is the gross investment in the lease less unearned finance income.

3.17 The interest rate implicit in the lease is the discount rate that, at the inception of the lease, causes the aggregate present value of

(a) the minimum lease payments under a finance lease from the standpoint of the lessor; and

(b) any unguaranteed residual value accruing to the lessor, to be equal to the fair value of the leased asset.

3.18 The lessee's incremental borrowing rate of interest is the rate of interest the lessee would have to pay on a similar lease or, if that is not determinable, the rate that, at the inception of the lease, the lessee would incur to borrow over a similar term, and with a similar security, the funds necessary to purchase the asset.

3.19 Contingent rent is that portion of the lease payments that is not fixed in amount but is based on a factor other than just the passage of time (e.g., percentage of sales, amount of usage, price indices, market rates of interest).

4. The definition of a lease includes agreements for the hire of an asset which contain a provision giving the hirer an option to acquire title to the asset upon the fulfillment of agreed conditions. These agreements are commonly known as hire purchase agreements. Hire purchase agreements include agreements under which the property in the asset is to pass to the hirer on the payment of the last

instalment and the hirer has a right to terminate the agreement at any time before the property so passes.

Classification of Leases

5. The classification of leases adopted in this Standard is based on the extent to which risks and rewards incident to ownership of a leased asset lie with the lessor or the lessee. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return due to changing economic conditions. Rewards may be represented by the expectation of profitable operation over the economic life of the asset and of gain from appreciation in value or realisation of residual value.

6. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incident to ownership.

7. Since the transaction between a lessor and a lessee is based on a lease agreement common to both parties, it is appropriate to use consistent definitions. The application of these definitions to the dif fering circumstances of the two parties may sometimes result in the same lease being classified differently by the lessor and the lessee.

8. Whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than its form. Examples of situations which would normally lead to a lease being classified as a finance lease are:

(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;

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

(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;

(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and

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

9. Indicators of situations which individually or in combination could also lead to a lease being classified as a finance lease are:

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

(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equalling most of the sales proceeds at the end of the lease); and

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

10. Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, other than by renewing the lease, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 5 to 9 had the changed terms been in effect at the inception of the lease, the revised agreement is considered as a

new agreement over its revised term. Changes in estimates (for example, changes in estimates of the economic life or of the residual value of the leased asset) or changes in circumstances (for example, default by the lessee), however, do not give rise to a new classification of a lease for accounting purposes.

Leases in the Financial Statements of Lessees

Finance Leases

11. At the inception of a finance lease, the lessee should recognise the lease as an asset and a liability. Such recognition should be at an amount equal to the fair value of the leased asset at the inception of the lease. However, if the fair value of the leased asset exceeds the present value of the minimum lease payments from the standpoint of the lessee, the amount recorded as an asset and a liability should be the present value of the minimum lease payments from the standpoint of the lessee. In calculating the present value of the minimum lease payments the discount rate is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used.

Example

(a) An enterprise (the lessee) acquires a machinery on lease from a leasing company (the lessor) on January 1, 20X0. The lease term covers the entire economic life of the machinery, i.e., 3 years. The fair value of the machinery on January 1, 20X0 is Rs.2,35,500. The lease agreement requires the lessee to pay an amount of Rs.1,00,000 per year beginning December 31, 20X0. The lessee has guaranteed a residual value of Rs.17,000 on December 31, 20X2 to the lessor. The lessor, however, estimates that the machinery would have a salvage value of only Rs.3,500 on December 31, 20X2.

The interest rate implicit in the lease is 16 per cent (approx.). This is calculated using the following formula:

$$\text{Fair value} = \frac{ALR}{(1+r)1} + \frac{ALR}{(1+r)2} + \ldots \quad \frac{ALR}{(1+r)n} + \frac{RV}{(1+r)n}$$

where ALR is annual lease rental,

RV is residual value (both guaranteed and unguaranteed),

n is the lease term,

r is interest rate implicit in the lease.

The present value of minimum lease payments from the stand point of the lessee is ₹ 2,35,500.

The lessee would record the machinery as an asset at ₹ 2,35,500 with a corresponding liability representing the present value of lease payments over the lease term (including the guaranteed residual value).

(b) In the above example, suppose the lessor estimates that the machinery would have a salvage value of ₹ 17,000 on December 31, 20X2. The lessee, however, guarantees a residual value of ₹ 5,000 only.

The interest rate implicit in the lease in this case would remain unchanged at 16% (approx.). The present value of the minimum lease payments from the standpoint of the lessee, using this interest rate implicit in the lease, would be ₹ 2,27,805. As this amount is lower than the fair value of the leased asset (₹ 2,35,500), the lessee would recognise the asset and the liability arising from the lease at ₹ 2,27,805.

In case the interest rate implicit in the lease is not known to the lessee, the present value of the minimum lease payments from the standpoint of the lessee would be computed using the lessee's incremental borrowing rate.

12. Transactions and other events are accounted for and presented in accordance with their substance and financial reality and not merely with their legal form. While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

13. If such lease transactions are not reflected in the lessee's balance sheet, the economic resources and the level of obligations of an enterprise are understated thereby distorting financial ratios. It is therefore appropriate that a finance lease be recognised in the lessee's balance sheet both as an asset and as an obligation to pay future lease payments. At the inception of the lease, the asset and the liability for the future lease payments are recognised in the balance sheet at the same amounts.

14. It is not appropriate to present the liability for a leased asset as a deduction from the leased asset in the financial statements. The liability for a leased asset should be presented separately in the balance sheet as a current liability or a long-term liability as the case may be.

15. Initial direct costs are often incurred in connection with specific leasing activities, as in negotiating and securing leasing arrangements. The costs identified as directly attributable to activities performed by the lessee for a finance lease are included as part of the amount recognised as an asset under the lease.

16. Lease payments should be apportioned between the finance charge and the reduction of the outstanding liability. The finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period.

Example

In the example (a) illustrating paragraph 11, the lease payments would be apportioned by the lessee between the finance charge and the reduction of the outstanding liability as follows:

	Year	*Finance charge (₹)*	*Payment (₹)*	*Reduction in outstanding liability (₹)*	*Outstanding liability (₹)*
Year 1	(January 1)				2,35,500
	(December 31)	37,680	1,00,000	62,320	1,73,180
Year 2	(December 31)	27,709	1,00,000	72,291	1,00,889
Year 3	(December 31)	16,142	1,00,000	83,858	17,031*

* The difference between this figure and guaranteed residual value (Rs.17,000) is due to approximation in computing the interest rate implicit in the lease.

17. In practice, in allocating the finance charge to periods during the lease term, some form of approximation may be used to simplify the calculation.

18. A finance lease gives rise to a depreciation expense for the asset as well as a finance expense for each accounting period. The depreciation policy for a leased asset should be consistent with that for depreciable assets which are owned, and the depreciation recognised should be calculated on the basis set out in Accounting Standard (AS) 6, Depreciation Accounting. If there is no reasonable certainty that the lessee will obtain ownership by the end of the lease term, the asset should be fully depreciated over the lease term or its useful life, whichever is shorter.

19. The depreciable amount of a leased asset is allocated to each accounting period during the period of expected use on a systematic basis consistent with the depreciation policy the lessee adopts for depreciable assets that are owned. If there is reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the asset is depreciated over the lease term or its useful life, whichever is shorter.

20. The sum of the depreciation expense for the asset and the finance expense for the period is rarely the same as the lease payments payable for the period, and it is, therefore, inappropriate simply to recognise the lease payments payable as an expense in the statement of profit and loss. Accordingly, the asset and the related liability are unlikely to be equal in amount after the inception of the lease.

21. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[4], that sets out the requirements as to how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

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

- ***(a) assets acquired under finance lease as segregated from the assets owned;***
- ***(b) for each class of assets, the net carrying amount at the balance sheet date;***
- ***(c) a reconciliation between the total of minimum lease payments at the balance sheet date and their present value. In addition, an enterprise should disclose the total of minimum lease payments at the balance sheet date, and their present value, for each of the following periods:***
    - ***(i) not later than one year;***
    - ***(ii) later than one year and not later than five years; (iii) later than five years;***
- ***(d) contingent rents recognised as expense in the statement of profit and loss for the period;***
- ***(e) the total of future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date; and***

[4] Accounting Standard (AS) 28, 'Impairment of Assets',' specifies the requirements relating to impairment of assets.

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

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

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

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

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), may not comply with sub- paragraphs (c), (e) and (f).

Operating Leases

23. Lease payments under an operating lease should be recognised as an expense in the statement of profit and loss on a straight line basis over the lease term unless another systematic basis is more representative of the time pattern of the user's benefit.

24. For operating leases, lease payments (excluding costs for services such as insurance and maintenance) are recognised as an expense in the statement of profit and loss on a straight line basis unless another systematic basis is more representative of the time pattern of the user's benefit, even if the payments are not on that basis.

25. The lessee should make the following disclosures for operating leases:

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

(i) not later than one year;

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

(iii) later than five years;

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

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

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

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

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

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

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

Provided that a Small and Medium Sized Company and a Small and Medium Sized Enterprise (Levels II and III non-corporate entities), may not comply with sub- paragraphs (a), (b) and (e).

Leases in the Financial Statements of Lessors

Finance Leases

26. The lessor should recognise assets given under a finance lease in its balance sheet as a receivable at an amount equal to the net investment in the lease.

27. Under a finance lease substantially all the risks and rewards incident to legal ownership are transferred by the lessor, and thus the lease payment receivable is treated by the lessor as repayment of principal, i.e., net investment in the lease, and finance income to reimburse and reward the lessor for its investment and services.

28. The recognition of finance income should be based on a pattern reflecting a constant periodic rate of return on the net investment of the lessor outstanding in respect of the finance lease.

29. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. This income allocation is based on a pattern reflecting a constant periodic return on the net investment of the lessor outstanding in respect of the finance lease. Lease payments relating to the accounting period, excluding costs for services, are reduced from both the principal and the unearned finance income.

30. Estimated unguaranteed residual values used in computing the lessor's gross investment in a lease are reviewed regularly. If there has been a reduction in the estimated unguaranteed residual value, the income allocation over the remaining lease term is revised and any reduction in respect of amounts already accrued is recognised immediately. An upward adjustment of the estimated residual value is not made.

31. Initial direct costs, such as commissions and legal fees, are often incurred by lessors in negotiating and arranging a lease. For finance leases, these initial direct costs are incurred to produce finance income and are either recognised immediately in the statement of profit and loss or allocated against the finance income over the lease term.

32. The manufacturer or dealer lessor should recognise the transaction of sale in the statement of profit and loss for the period, in accordance with the policy followed by the enterprise for outright sales. If artificially low rates of interest are quoted, profit on sale should be restricted to that which would apply if a commercial rate of interest were charged. Initial direct costs should be recognised as an expense in the statement of profit and loss at the inception of the lease.

33. Manufacturers or dealers may offer to customers the choice of either buying or leasing an asset. A finance lease of an asset by a manufacturer or dealer lessor gives rise to two types of income:

(a) the profit or loss equivalent to the profit or loss resulting from an outright sale of the asset being leased, at normal selling prices, reflecting any applicable volume or trade discounts; and

(b) the finance income over the lease term.

34. The sales revenue recorded at the commencement of a finance lease term by a manufacturer or dealer lessor is the fair value of the asset. However, if the present value of the minimum lease payments accruing to the lessor computed at a commercial rate of interest is lower than the fair value, the amount recorded as sales revenue is the present value so computed. The cost of sale recognised at the commencement of the lease term is the cost, or carrying amount if different, of the leased asset less the present value of the unguaranteed residual value. The difference between the sales revenue

and the cost of sale is the selling profit, which is recognised in accordance with the policy followed by the enterprise for sales.

35. Manufacturer or dealer lessors sometimes quote artificially low rates of interest in order to attract customers. The use of such a rate would result in an excessive portion of the total income from the transaction being recognised at the time of sale. If artificially low rates of interest are quoted, selling profit would be restricted to that which would apply if a commercial rate of interest were charged.

36. Initial direct costs are recognised as an expense at the commencement of the lease term because they are mainly related to earning the manufacturer's or dealer's selling profit.

37. The lessor should make the following disclosures for finance leases:

- ***(a) a reconciliation between the total gross investment in the lease at the balance sheet date, and the present value of minimum lease payments receivable at the balance sheet date. In addition, an enterprise should disclose the total gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:***
    - ***(i) not later than one year;***
    - ***(ii) later than one year and not later than five years;***
    - ***(iii) later than five years;***
- ***(b) unearned finance income;***
- ***(c) the unguaranteed residual values accruing to the benefit of the lessor;***
- ***(d) the accumulated provision for uncollectible minimum lease payments receivable;***
- ***(e) contingent rents recognised in the statement of profit and loss for the period;***
- ***(f) a general description of the significant leasing arrangements of the lessor; and***
- ***(g) accounting policy adopted in respect of initial direct costs.***

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level III, as defined in Appendix 1 to this Compendium, may not comply with sub- paragraphs (a) and (f). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, may not comply with sub-paragraph (g) also.

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

Operating Leases

39. The lessor should present an asset given under operating lease in its balance sheet under fixed assets.

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

41. Costs, including depreciation, incurred in earning the lease income are recognised as an expense. Lease income (excluding receipts for services provided such as insurance and maintenance) is recognised in the statement of profit and loss on a straight line basis over the lease term even if the

receipts are not on such a basis, unless another systematic basis is more representative of the time pattern in which benefit derived from the use of the leased asset is diminished.

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

43. The depreciation of leased assets should be on a basis consistent with the normal depreciation policy of the lessor for similar assets, and the depreciation charge should be calculated on the basis set out in AS 6, Depreciation Accounting.

44. To determine whether a leased asset has become impaired, an enterprise applies the Accounting Standard dealing with impairment of assets[5] that sets out the requirements for how an enterprise should perform the review of the carrying amount of an asset, how it should determine the recoverable amount of an asset and when it should recognise, or reverse, an impairment loss.

45. A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

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

- ***(a) for each class of assets, the gross carrying amount, the accumulated depreciation and accumulated impairment losses at the balance sheet date; and***
  - ***(i) the depreciation recognised in the statement of profit and loss for the period;***
  - ***(ii) impairment losses recognised in the statement of profit and loss for the period;***
  - ***(iii) impairment losses reversed in the statement of profit and loss for the period;***
- ***(b) the future minimum lease payments under non-cancellable operating leases in the aggregate and for each of the following periods:***
  - ***(i) not later than one year;***
  - ***(ii) later than one year and not later than five years;***
  - ***(iii) later than five years;***
- ***(c) total contingent rents recognised as income in the statement of profit and loss for the period;***
- ***(d) a general description of the lessor 's significant leasing arrangements; and***
- ***(e) accounting policy adopted in respect of initial direct costs.***

Provided that a Small and Medium Sized Company and a non-corporate Small and Medium Sized Enterprise falling in Level II and Level III, may not comply with sub- paragraphs (b) and (d). Further, a non-corporate Small and Medium Sized Enterprise falling in Level III, as defined in Appendix 1 to this Compendium, may not comply with sub-paragraph (e) also.

---

[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

Sale and Leaseback Transactions

47. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor. The lease payments and the sale price are usually interdependent as they are negotiated as a package. The accounting treatment of a sale and leaseback transaction depends upon the type of lease involved.

48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

49. If the leaseback is a finance lease, it is not appropriate to regard an excess of sales proceeds over the carrying amount as income. Such excess is deferred and amortised over the lease term in proportion to the depreciation of the leased asset. Similarly, it is not appropriate to regard a deficiency as loss. Such deficiency is deferred and amortised over the lease term.

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

51. If the leaseback is an operating lease, and the lease payments and the sale price are established at fair value, there has in effect been a normal sale transaction and any profit or loss is recognised immediately.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately.

53. For finance leases, no such adjustment is necessary unless there has been an impairment in value, in which case the carrying amount is reduced to recoverable amount in accordance with the Accounting Standard dealing with impairment of assets.

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in paragraph 12 of Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

Illustration

Sale and Leaseback Transactions that Result in Operating Leases

The illustration does not form part of the accounting standard. Its purpose is to illustrate the application of the accounting standard.

A sale and leaseback transaction that results in an operating lease may give rise to profit or a loss, the determination and treatment of which depends on the leased asset's carrying amount, fair value and selling price. The following table shows the requirements of the accounting standard in various circumstances.

Sale price established at fair value (paragraph 50)	Carrying amount equal to fair value	Carrying amount less than fair value	Carrying amount above fair value
Profit	No profit	Recognise profit immediately	Not applicable
Loss	No loss	Not applicable	Recognise loss immediately

Sale price below fair value			
Profit	No profit	Recognise profit immediately	No profit (note 1)
Loss not compensated by future lease payments at below	Recognise loss immediately	Recognise loss immediately	(note 1)
Loss compensated by future lease payments at below market price	Defer and amortise loss	Defer and amortise loss	(note 1)

Sale price above fair value (paragraph 50)			
Profit	Defer and amortise profit	Defer and amortise profit	Defer and amortise profit (note 2)
Loss	No loss	No loss	(note 1)

Note 1 These parts of the table represent circumstances that would have been dealt with under paragraph 52 of the Standard. Paragraph 52 requires the carrying amount of an asset to be written down to fair value where it is subject to a sale and leaseback.

Note 2 The profit would be the difference between fair value and sale price as the carrying amount would have been written down to fair value in accordance with paragraph 52.

AS 20* - Earnings Per Share

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should*

* Issued in 2001. A limited revision to this Standard was made in 2004, pursuant to which paragraphs 48 and 51 of this Standard were revised.

be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]

Objective

The objective of this Standard is to prescribe principles for the determination and presentation of earnings per share which will improve comparison of performance among different enterprises for the same period and among different accounting periods for the same enterprise. The focus of this Standard is on the denominator of the earnings per share calculation. Even though earnings per share data has limitations because of different accounting policies used for determining 'earnings', a consistently determined denominator enhances the quality of financial reporting.

Scope

1. This Standard should be applied by all the entities. However, a Small and Medium Sized Company and a Small and Medium Sized non-corporate entity falling in Level II or Level III, as defined in Appendix 1 to this Compendium, 'Applicability of Accounting Standards to Various Entities', may not disclose diluted earning per share (both including and excluding extraordinary items). Further, a non-corporate Small and Medium Sized Entity falling in level III as defined in Appendix 1 to this Compendium, may not disclose the information required by paragraph 48(ii) of the standard.

2. In consolidated financial statements, the information required by this Standard should be presented on the basis of consolidated information[2]

3. In the case of a parent (holding enterprise), users of financial statements are usually concerned with, and need to be informed about, the results of operations of both the enterprise itself as well as of the group as a whole. Accordingly, in the case of such enterprises, this Standard requires the presentation of earnings per share information on the basis of consolidated financial statements as well as individual financial statements of the parent. In consolidated financial statements, such information is presented on the basis of consolidated information.

Definitions

4. For the purpose of this Standard, the following terms are used with the meanings specified:

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

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

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

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

---

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

[2] Accounting Standard (AS) 21, 'Consolidated Financial Statements', specifies the requirements relating to consolidated financial statements.

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

4.6 Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

5. Equity shares participate in the net profit for the period only after preference shares. An enterprise may have more than one class of equity shares. Equity shares of the same class have the same rights to receive dividends.

6. A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity shares of another enterprise. For this purpose, a financial asset is any asset that is

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity share of another enterprise.

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

7. Examples of potential equity shares are:

(a) debt instruments or preference shares, that are convertible into equity shares;

(b) share warrants;

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

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

Presentation

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

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

Measurement

Basic Earnings Per Share

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

Earnings - Basic

11. For the purpose of calculating basic earnings per share, the net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting preference dividends and any attributable tax thereto for the period.

12. All items of income and expense which are recognised in a period, including tax expense and extraordinary items, are included in the determination of the net profit or loss for the period unless an Accounting Standard requires or permits otherwise *(see Accounting Standard (AS) 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies).* The amount of preference dividends and any attributable tax thereto for the period is deducted from the net profit for the period (or added to the net loss for the period) in order to calculate the net profit or loss for the period attributable to equity shareholders.

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

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

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

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

Per Share - Basic

15. For the purpose of calculating basic earnings per share, the number of equity shares should be the weighted average number of equity shares outstanding during the period.

16. The weighted average number of equity shares outstanding during the period reflects the fact that the amount of shareholders' capital may have varied during the period as a result of a larger or lesser number of shares outstanding at any time. It is the number of equity shares outstanding at the beginning of the period, adjusted by the number of equity shares bought back or issued during the period multiplied by the time-weighting factor. The time-weighting factor is the number of days for which the specific shares are outstanding as a proportion of the total number of days in the period; a reasonable approximation of the weighted average is adequate in many circumstances.

Illustration I attached to the Standard illustrates the computation of weighted average number of shares.

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

(a) equity shares issued in exchange for cash are included when cash is receivable;

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

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

(d) equity shares issued in exchange for the settlement of a liability of the enterprise are included as of the date the settlement becomes effective;

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

(f) equity shares issued for the rendering of services to the enterprise are included as the services are rendered.

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

18. Equity shares issued as part of the consideration in an amalgamation in the nature of purchase are included in the weighted average number of shares as of the date of the acquisition because the transferee incorporates the results of the operations of the transferor into its statement of profit and loss as from the date of acquisition. Equity shares issued during the reporting period as part of the consideration in an amalgamation in the nature of merger are included in the calculation of the weighted average number of shares from the beginning of the reporting period because the financial statements of the combined enterprise for the reporting period are prepared as if the combined entity had existed from the beginning of the reporting period. Therefore, the number of equity shares used for the calculation of basic earnings per share in an amalgamation in the nature of merger is the aggregate of the weighted average number of shares of the combined enterprises, adjusted to equivalent shares of the enterprise whose shares are outstanding after the amalgamation.

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

Illustration II attached to the Standard illustrates the computations in respect of partly paid equity shares.

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

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

22. The weighted average number of equity shares outstanding during the period and for all periods presented should be adjusted for events, other than the conversion of potential equity shares, that have changed the number of equity shares outstanding, without a corresponding change in resources.

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

(a) a bonus issue;

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

(c) a share split; and

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

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

proportionate change in the number of equity shares outstanding as if the event had occurred at the beginning of the earliest period reported. For example, upon a two-for-one bonus issue, the number of shares outstanding prior to the issue is multiplied by a factor of three to obtain the new total number of shares, or by a factor of two to obtain the number of additional shares.

Illustration III attached to the Standard illustrates the computation of weighted average number of equity shares in case of a bonus issue during the period.

25. The issue of equity shares at the time of exercise or conversion of potential equity shares will not usually give rise to a bonus element, since the potential equity shares will usually have been issued for full value, resulting in a proportionate change in the resources available to the enterprise. In a rights issue, on the other hand, the exercise price is often less than the fair value of the shares. Therefore, a rights issue usually includes a bonus element. The number of equity shares to be used in calculating basic earnings per share for all periods prior to the rights issue is the number of equity shares outstanding prior to the issue, multiplied by the following factor:

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

The theoretical ex-rights fair value per share is calculated by adding the aggregate fair value of the shares immediately prior to the exercise of the rights to the proceeds from the exercise of the rights, and dividing by the number of shares outstanding after the exercise of the rights. Where the rights themselves are to be publicly traded separately from the shares prior to the exercise date, fair value for the purposes of this calculation is established at the close of the last day on which the shares are traded together with the rights.

Illustration IV attached to the Standard illustrates the computation of weighted average number of equity shares in case of a rights issue during the period.

Diluted Earnings Per Share

26. For the purpose of calculating diluted earnings per share, the net profit or loss for the period attributable to equity shareholders and the weighted average number of shares outstanding during the period should be adjusted for the effects of all dilutive potential equity shares.

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

(a) the net profit for the period attributable to equity shares is:

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

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

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

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

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

Earnings - Diluted

29. For the purpose of calculating diluted earnings per share, the amount of net profit or loss for the period attributable to equity shareholders, as calculated in accordance with paragraph 11, should be adjusted by the following, after taking into account any attributable change in tax expense for the period:

- ***(a) any dividends on dilutive potential equity shares which have been deducted in arriving at the net profit attributable to equity shareholders as calculated in accordance with paragraph 11;***
- ***(b) interest recognised in the period for the dilutive potential equity shares; and***
- ***(c) any other changes in expenses or income that would result from the conversion of the dilutive potential equity shares.***

30. After the potential equity shares are converted into equity shares, the dividends, interest and other expenses or income associated with those potential equity shares will no longer be incurred (or earned). Instead, the new equity shares will be entitled to participate in the net profit attributable to equity shareholders. Therefore, the net profit for the period attributable to equity shareholders calculated in accordance with paragraph 11 is increased by the amount of dividends, interest and other expenses that will be saved, and reduced by the amount of income that will cease to accrue, on the conversion of the dilutive potential equity shares into equity shares. The amounts of dividends, interest and other expenses or income are adjusted for any attributable taxes.

Illustration V attached to the standard illustrates the computation of diluted earnings in case of convertible debentures.

31. The conversion of some potential equity shares may lead to consequential changes in other items of income or expense. For example, the reduction of interest expense related to potential equity shares and the resulting increase in net profit for the period may lead to an increase in the expense relating to a non-discretionary employee profit sharing plan. For the purpose of calculating diluted earnings per share, the net profit or loss for the period is adjusted for any such consequential changes in income or expenses.

Per Share - Diluted

32. For the purpose of calculating diluted earnings per share, the number of equity shares should be the aggregate of the weighted average number of equity shares calculated in accordance with paragraphs 15 and 22, and the weighted average number of equity shares which would be issued on the conversion of all the dilutive potential equity shares into equity shares. Dilutive potential equity shares should be deemed to have been converted into equity shares at the beginning of the period or, if issued later, the date of the issue of the potential equity shares.

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

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

35. For the purpose of calculating diluted earnings per share, an enterprise should assume the exercise of dilutive options and other dilutive potential equity shares of the enterprise. The assumed proceeds from these issues should be considered to have been received from the issue of shares at fair value. The difference between the number of shares issuable and the number of shares that would have been issued at fair value should be treated as an issue of equity shares for no consideration.

36. Fair value for this purpose is the average price of the equity shares during the period. Theoretically, every market transaction for an enterprise's equity shares could be included in determining the average price. As a practical matter, however, a simple average of last six months weekly closing prices are usually adequate for use in computing the average price.

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

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

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

Illustration VI attached to the Standard illustrates the effects of share options on diluted earnings per share.

38. To the extent that partly paid shares are not entitled to participate in dividends during the reporting period they are considered the equivalent of warrants or options.

Dilutive Potential Equity Shares

39. Potential equity shares should be treated as dilutive when, and only when, their conversion to equity shares would decrease net profit per share from continuing ordinary operations.

40. An enterprise uses net profit from continuing ordinary activities as "the control figure" that is used to establish whether potential equity shares are dilutive or anti-dilutive. The net profit from continuing ordinary activities is the net profit from ordinary activities (as defined in AS 5) after deducting

preference dividends and any attributable tax thereto and after excluding items relating to discontinued operations[3].

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

42. In considering whether potential equity shares are dilutive or anti- dilutive, each issue or series of potential equity shares is considered separately rather than in aggregate. The sequence in which potential equity shares are considered may affect whether or not they are dilutive. Therefore, in order to maximise the dilution of basic earnings per share, each issue or series of potential equity shares is considered in sequence from the most dilutive to the least dilutive. For the purpose of determining the sequence from most dilutive to least dilutive potential equity shares, the earnings per incremental potential equity share is calculated. Where the earnings per incremental share is the least, the potential equity share is considered most dilutive and vice-versa.

Illustration VII attached to the Standard illustrates the manner of determining the order in which dilutive securities should be included in the computation of weighted average number of shares.

43. Potential equity shares are weighted for the period they were outstanding. Potential equity shares that were cancelled or allowed to lapse during the reporting period are included in the computation of diluted earnings per share only for the portion of the period during which they were outstanding. Potential equity shares that have been converted into equity shares during the reporting period are included in the calculation of diluted earnings per share from the beginning of the period to the date of conversion; from the date of conversion, the resulting equity shares are included in computing both basic and diluted earnings per share.

Restatement

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

45. An enterprise does not restate diluted earnings per share of any prior period presented for changes in the assumptions used or for the conversion of potential equity shares into equity shares outstanding.

46. An enterprise is encouraged to provide a description of equity share transactions or potential equity share transactions, other than bonus issues, share splits and reverse share splits (consolidation of shares) which occur after the balance sheet date when they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions. Examples of such transactions include:

(a) the issue of shares for cash;

[3] Accounting Standard (AS) 24, 'Discontinuing Operations', specifies the requirements in respect of discontinued operations.

(b) the issue of shares when the proceeds are used to repay debt or preference shares outstanding at the balance sheet date;

(c) the cancellation of equity shares outstanding at the balance sheet date;

(d) the conversion or exercise of potential equity shares, outstanding at the balance sheet date, into equity shares;

(e) the issue of warrants, options or convertible securities; and

(f) the satisfaction of conditions that would result in the issue of contingently issuable shares.

47. Earnings per share amounts are not adjusted for such transactions occurring after the balance sheet date because such transactions do not affect the amount of capital used to produce the net profit or loss for the period.

Disclosure

48. In addition to disclosures as required by paragraphs 8, 9 and 44 of this Standard, an enterprise should disclose the following:

(i) where the statement of profit and loss includes extraordinary items (within the meaning of AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies), the enterprise should disclose basic and diluted earnings per share computed on the basis of earnings excluding extraordinary items (net of tax expense); and

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

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

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

Provided that a non-corporate Small and Medium Sized Entity Falling in Level III, 'Applicability of Accounting Standards to Various Entities', may not comply with sub-paragraph (ii).

49. Contracts generating potential equity shares may incorporate terms and conditions which affect the measurement of basic and diluted earnings per share. These terms and conditions may determine whether or not any potential equity shares are dilutive and, if so, the effect on the weighted average number of shares outstanding and any consequent adjustments to the net profit attributable to equity shareholders. Disclosure of the terms and conditions of such contracts is encouraged by this Standard.

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

51. An enterprise may wish to disclose more information than this Standard requires. Such information may help the users to evaluate the performance of the enterprise and may take the form of

per share amounts for various components of net profit. Such disclosures are encouraged. However, when such amounts are disclosed, the denominators need to be calculated in accordance with this Standard in order to ensure the comparability of the per share amounts disclosed.

Illustrations

Note: These illustrations do not form part of the Accounting Standard. Their purpose is to illustrate the application of the Accounting Standard.

Illustration I

Example - Weighted Average Number of Shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of Shares Issued	*No. of Shares Bought Back*	*No. of Shares Outstanding*
1st January, 20X1	Balance at beginning of year	1,800	-	1,800
31st May,20X1	Issue of shares for cash	600	-	2,400
1st Nov., 20X1	Buy Back of shares	-	300	2,100
31st Dec., 20X1	Balance at end of year	2,400	300	2,100

Computation of Weighted Average:

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

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

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

Example – Partly paid shares

(Accounting year 01-01-20X1 to 31-12-20X1)

		No. of shares issued	*Nominal value of shares*	*Amount paid*
1st January, 20X1	Balance at beginning of year	1,800	₹ 10	₹ 10
31st October, 20X1	Issue of Shares	600	₹ 10	₹ 5

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

Computation of weighted average would be as follows:

(1,800x12/12) + (300x2/12) = 1,850 shares.

Illustration III

Example - Bonus Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X0	₹ 18,00,000
Net profit for the year 20X1	₹ 60,00,000
No. of equity shares outstanding until 30th September 20X1	20,00,000
Bonus issue 1st October 20X1	2 equity shares for each equity share outstanding at 30th September, 20X1 20,00,000 x 2 = 40,00,000
Earnings per share for the year 20X1	₹ 60,00,000 =₹ 1.00 (20,00,000 + 40,00,000)
Adjusted earnings per share for the year 20X0	₹ 18,00,000 = ₹ 0.30 (20,00,000 + 40,00,000)
Since the bonus issue is an issue without consideration, the issue is treated as if it had occurred prior to the beginning of the year 20X0, the earliest period reported.	

Example - Rights Issue

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit	Year 20X0 : ₹ 11,00,000 Year 20X1 : ₹ 15,00,000
No. of shares outstanding prior to rights issue	5,00,000 shares
lights issue	One new share for each five outstanding (i.e. 1,00,000 new shares) Rights issue price : ₹ 15.00 Last date to exercise rights: 1st March 20X1
Fair value of one equity share immediately prior to exercise of rights on 1st March 20X1	₹ 21.00

Computation of theoretical ex-rights fair value per share

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

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

Theoretical ex-rights fair value per share = ₹ 20.00

Computation of adjustment factor

$$\frac{\text{Fair value per share prior to exercise of rights}}{\text{Theoretical ex-rights value per share}} = \frac{\text{Rs. } (21.00)}{\text{Rs. } (20.00)} = 1.05$$

Computation of earnings per share

	Year 20X0	Year 20X1
EPS for the year 20X0 as originally reported: Rs.11,00,000/5,00,000 shares	₹ 2.20	
EPS for the year 20X0 restated for rights issue: Rs.11,00,000/ (5,00,000 shares x 1.05)	₹ 2.10	
EPS for the year 20X1 including effects of rights issue $\frac{\text{Rs. } 15,00,000}{(5,00,000 \times 1.05 \times 2/12) + (6,00,000 \times 10/12)}$		₹ 2.55

Example - Convertible Debentures

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the current year	₹ 1,00,00,000
No. of equity shares outstanding	50,00,000
Basic earnings per share	₹ 2.00
No. of 12% convertible debentures of ₹ 100 each Each debenture is convertible into 10 equity shares	1,00,000
Interest expense for the current year	₹ 12,00,000
Tax relating to interest expense (30%)	₹ 3,60,000
Adjusted net profit for the current year	₹ (1,00,00,000 + 12,00,000 -3,60,000) = ₹ 1,08,40,000

No. of equity shares resulting from conversion of debentures	10,00,000
No. of equity shares used to compute diluted earnings per share	50,00,000 + 10,00,000 =60,00,000
Diluted earnings per share	1,08,40,000/60,00,000 = Re. 1.81

Illustration VI

Example - Effects of Share Options on Diluted Earnings Per Share

(Accounting year 01-01-20XX to 31-12-20XX)

Net profit for the year 20X1	₹ 12,00,000
Weighted average number of equity shares outstanding during the year 20X1	5,00,000 shares
Average fair value of one equity share during the year 20X1	₹ 20.00
Weighted average number of shares under option during the year 20X1	1,00,000 shares
Exercise price for shares under option during the year 20X1	₹ 15.00

Computation of earnings per share

	Earnings	*Shares*	*Earnings per share*
Net profit for the year 20X1	₹ 12,00,000		
Weighted average number of shares outstanding during year 20X1		5,00,000	
Basic earnings per share			₹ 2.40
Number of shares under option		1,00,000	
Number of shares that would have been issued at fair value: (100,000 x 15.00)/20.00	*	(75,000)	
Diluted earnings per share	₹ 12,00,000	5,25,000	₹ 2.29
**The earnings have not been increased as the total number of shares has been increased only by the number of shares (25,000) deemed for the purpose of the computation to have been issued for no consideration {see para 37(b)}*			

Illustration VII

Example - Determining the Order in Which to Include Dilutive Securities in the Computation of Weighted Average Number of Shares (Accounting year 01-01-20XX to 31-12-20XX)

Earnings, i.e., Net profit attributable to equity shareholders	₹ 1,00,00,000
No. of equity shares outstanding	20,00,000
Average fair value of one equity share during the year	₹ 75.00
Potential Equity Shares	
Options	1,00,000 with exercise price of ₹ 60
Convertible Preference Shares Attributable tax, e.g., corporate dividend tax	8,00,000 shares entitled to a cumulative dividend of ₹ 8 per share. Each preference share is convertible into 2 equity shares.10%
12% Convertible Debentures of ₹ 100 each	Nominal amount ₹ 10,00,00,000. Each debenture is convertible into 4 equity shares.
Tax rate	30%

Increase in Earnings Attributable to Equity Shareholders on Conversion of Potential Equity Shares

	Increase in Earnings	*crease in no. of Equity Shares*	*Earnings per Incremental Share*
Options			
Increase in earnings	Nil		
No. of incremental shares issued for no consideration {1,00,000 x (75 - 60) / 75}		20,000	Nil
Convertible Preference Shares			
Increase in net profit attributable to equity shareholders as adjusted by attributable tax [(Rs.8 x 8,00,000)+ 10% (8 x 8,00,000)]	₹ 70,40,000		
No. of incremental shares {2 x 8,00,000}		16,00,000	₹ 4.40

12% Convertible Debentures			
Increase in net profit {₹ 10,00,00,000 x 0.12 x (1-0.30)}	₹ 84,00,000		
No. of incremental shares {10,00,000 x 4}		40,00,000	₹ 2.10

It may be noted from the above that options are most dilutive as their earnings per incremental share is nil. Hence, for the purpose of computation of diluted earnings per share, options will be considered first. 12% convertible debentures being second most dilutive will be considered next and thereafter convertible preference shares will be considered (see para 42).

Conversion of Diluted Earnings Per Shares

	Net Profit Attributable (₹)	*No. of Equity Shares*	*Net profit attributable Per Share (₹)*	
As reported	1,00,00,000	20,00,000	5.00	
Options	____	20,000		
	1,00,00,000	20,20,000	4.95	Dilutive
12% Convertible Debentures	84,00,000	40,00,000		
	1,84,00,000	60,20,000	3.06	Dilutive
Convertible Preference Shares	70,40,000	16,00,000		
	2,54,40,000	76,20,000	3.34	Anti- Dilutive

Since diluted earnings per share is increased when taking the convertible preference shares into account (from ₹ 3.06 to Rs 3.34), the convertible preference shares are anti-dilutive and are ignored in the calculation of diluted earnings per share. Therefore, diluted earnings per share is ₹ 3.06.

An Exposure Draft on Limited Revision on AS 20 has recently been issued by ICAI to address the conceptual issues in arriving at earnings for computation of EPS. The Companies Act allows various adjustments in the Securities Premium Account, which are inconsistent with the requirements of AS 20. According to this Exposure Draft on Limited Revision, for purpose of calculating basic earnings per share, net profit or loss for the period attributable to equity shareholders should be the net profit or loss for the period after deducting (i) preference dividends and any attributable tax thereto for the period and (ii) adjusting the amount in respect of an item of income or expense which is debited or credited to share premium account/ reserves, that is otherwise required to be recognized in the statement of profit and loss in accordance with accounting standards. It is pertinent to note that this Limited Revision is yet to be notified by the Govt. The same will come into effect as and when it will be notified by the Govt.

AS 26* : Intangible Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

Objective

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

Scope

1. This Standard should be applied by all enterprises in accounting for intangible assets, except:

- ***(a) intangible assets that are covered by another Accounting Standard;***
- ***(b) financial assets[2];***
- ***(c) mineral rights and expenditure on the exploration for, or development and extraction of, minerals, oil, natural gas and similar non-regenerative resources; and***
- ***(d) intangible assets arising in insurance enterprises from contracts with policyholders.***

This Standard should not be applied to expenditure in respect of termination benefits[3] also.

2. If another Accounting Standard deals with a specific type of intangible asset, an enterprise applies that Accounting Standard instead of this Standard. For example, this Standard does not apply to:

- (a) intangible assets held by an enterprise for sale in the ordinary course of business (see AS 2, Valuation of Inventories, and AS 7, Construction Contracts);
- (b) deferred tax assets (see AS 22, Accounting for Taxes on Income);
- (c) leases that fall within the scope of AS 19, Leases; and
- (d) goodwill arising on an amalgamation (see AS 14, Accounting for Amalgamations) and goodwill arising on consolidation (see AS 21, Consolidated Financial Statements).

---

* Issued in 2002.

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2 A financial asset is any asset that is :

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an ownership interest in another enterprise.

3 Termination benefits are employee benefits payable as a result of either:

3. This Standard applies to, among other things, expenditure on advertising, training, start-up, research and development activities. Research and development activities are directed to the development of knowledge. Therefore, although these activities may result in an asset with physical substance (for example, a prototype), the physical element of the asset is secondary to its intangible component, that is the knowledge embodied in it. This Standard also applies to rights under licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights. These items are excluded from the scope of AS 19.

4. In the case of a finance lease, the underlying asset may be either tangible or intangible. After initial recognition, a lessee deals with an intangible asset held under a finance lease under this Standard.

5. Exclusions from the scope of an Accounting Standard may occur if certain activities or transactions are so specialised that they give rise to accounting issues that may need to be dealt with in a different way. Such issues arise in the expenditure on the exploration for, or development and extraction of, oil, gas and mineral deposits in extractive industries and in the case of contracts between insurance enterprises and their policyholders. Therefore, this Standard does not apply to expenditure on such activities. However, this Standard applies to other intangible assets used (such as computer software), and other expenditure (such as start-up costs), in extractive industries or by insurance enterprises. Accounting issues of specialised nature also arise in respect of accounting for discount or premium relating to borrowings and ancillary costs incurred in connection with the arrangement of borrowings, share issue expenses and discount allowed on the issue of shares. Accordingly, this Standard does not apply to such items also.

Definitions

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

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

6.2 An asset is a resource:

(a) controlled by an enterprise as a result of past events; and

(b) from which future economic benefits are expected to flow to the enterprise.

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

6.4 Non-monetary assets are assets other than monetary assets.

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

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

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

6.8 Depreciable amount is the cost of an asset less its residual value.

6.9 Useful life is either:

(a) the period of time over which an asset is expected to be used by the enterprise; or

(b) the number of production or similar units expected to be obtained from the asset by the enterprise.

6.10. Residual value is the amount which an enterprise expects to obtain for an asset at the end of its useful life after deducting the expected costs of disposal.

6.11. Fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

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

(a) the items traded within the market are homogeneous;

(b) willing buyers and sellers can normally be found at any time; and

(c) prices are available to the public.

6.13. An impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount[4].

6.14. Carrying amount is the amount at which an asset is recognised in the balance sheet, net of any accumulated amortisation and accumulated impairment losses thereon.

Intangible Assets

7. Enterprises frequently expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. Goodwill is another example of an item of intangible nature which either arises on acquisition or is internally generated.

8. Not all the items described in paragraph 7 will meet the definition of an intangible asset, that is, identifiability, control over a resource and expectation of future economic benefits flowing to the enterprise. If an item covered by this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred. However, if the item is acquired in an amalgamation in the nature of purchase, it forms part of the goodwill recognised at the date of the amalgamation (see paragraph 55).

9. Some intangible assets may be contained in or on a physical substance such as a compact disk (in the case of computer software), legal documentation (in the case of a licence or patent) or film (in the case of motion pictures). The cost of the physical substance containing the intangible assets is usually not significant. Accordingly, the physical substance containing an intangible asset, though tangible in nature, is commonly treated as a part of the intangible asset contained in or on it.

10. In some cases, an asset may incorporate both intangible and tangible elements that are, in practice, inseparable. In determining whether such an asset should be treated under AS 10, Accounting for Fixed Assets, or as an intangible asset under this Standard, judgement is required to assess as to which element is predominant. For example, computer software for a computer controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is

[4] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

treated as a fixed asset. The same applies to the operating system of a computer. Where the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

Identifiability

11. The definition of an intangible asset requires that an intangible asset be identifiable. To be identifiable, it is necessary that the intangible asset is clearly distinguished from goodwill. Goodwill arising on an amalgamation in the nature of purchase represents a payment made by the acquirer in anticipation of future economic benefits. The future economic benefits may result from synergy between the identifiable assets acquired or from assets which, individually, do not qualify for recognition in the financial statements but for which the acquirer is prepared to make a payment in the amalgamation.

12. An intangible asset can be clearly distinguished from goodwill if the asset is separable. An asset is separable if the enterprise could rent, sell, exchange or distribute the specific future economic benefits attributable to the asset without also disposing of future economic benefits that flow from other assets used in the same revenue earning activity.

13. Separability is not a necessary condition for identifiability since an enterprise may be able to identify an asset in some other way. For example, if an intangible asset is acquired with a group of assets, the transaction may involve the transfer of legal rights that enable an enterprise to identify the intangible asset. Similarly, if an internal project aims to create legal rights for the enterprise, the nature of these rights may assist the enterprise in identifying an underlying internally generated intangible asset. Also, even if an asset generates future economic benefits only in combination with other assets, the asset is identifiable if the enterprise can identify the future economic benefits that will flow from the asset.

Control

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

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

16. An enterprise may have a team of skilled staff and may be able to identify incremental staff skills leading to future economic benefits from training. The enterprise may also expect that the staff will continue to make their skills available to the enterprise. However, usually an enterprise has insufficient control over the expected future economic benefits arising from a team of skilled staff and from training to consider that these items meet the definition of an intangible asset. For a similar reason, specific management or technical talent is unlikely to meet the definition of an intangible asset, unless it is protected by legal rights to use it and to obtain the future economic benefits expected from it, and it also meets the other parts of the definition.

17. An enterprise may have a portfolio of customers or a market share and expect that, due to its efforts in building customer relationships and loyalty, the customers will continue to trade with the enterprise. However, in the absence of legal rights to protect, or other ways to control, the

relationships with customers or the loyalty of the customers to the enterprise, the enterprise usually has insufficient control over the economic benefits from customer relationships and loyalty to consider that such items (portfolio of customers, market shares, customer relationships, customer loyalty) meet the definition of intangible assets.

Future Economic Benefits

18. The future economic benefits flowing from an intangible asset may include revenue from the sale of products or services, cost savings, or other benefits resulting from the use of the asset by the enterprise. For example, the use of intellectual property in a production process may reduce future production costs rather than increase future revenues.

Recognition and Initial Measurement of an Intangible Asset

19. The recognition of an item as an intangible asset requires an enterprise to demonstrate that the item meets the:

(a) definition of an intangible asset (see paragraphs 6-18); and

(b) recognition criteria set out in this Standard (see paragraphs 20-54).

20. An intangible asset should be recognised if, and only if:

(a) it is probable that the future economic benefits that are attributable to the asset will flow to the enterprise; and

(b) the cost of the asset can be measured reliably.

21. An enterprise should assess the probability of future economic benefits using reasonable and supportable assumptions that represent best estimate of the set of economic conditions that will exist over the useful life of the asset.

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

23. An intangible asset should be measured initially at cost.

Separate Acquisition

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

25. The cost of an intangible asset comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities), and any directly attributable expenditure on making the asset ready for its intended use. Directly attributable expenditure includes, for example, professional fees for legal services. Any trade discounts and rebates are deducted in arriving at the cost.

26. If an intangible asset is acquired in exchange for shares or other securities of the reporting enterprise, the asset is recorded at its fair value, or the fair value of the securities issued, whichever is more clearly evident.

Acquisition as Part of an Amalgamation

27. An intangible asset acquired in an amalgamation in the nature of purchase is accounted for in accordance with Accounting Standard (AS) 14, Accounting for Amalgamations. Where in preparing the financial statements of the transferee company, the consideration is allocated to individual identifiable

assets and liabilities on the basis of their fair values at the date of amalgamation, paragraphs 28 to 32 of this Standard need to be considered.

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

29. If no active market exists for an asset, its cost reflects the amount that the enterprise would have paid, at the date of the acquisition, for the asset in an arm's length transaction between knowledgeable and willing parties, based on the best information available. In determining this amount, an enterprise considers the outcome of recent transactions for similar assets.

30. Certain enterprises that are regularly involved in the purchase and sale of unique intangible assets have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in an amalgamation in the nature of purchase if their objective is to estimate fair value as defined in this Standard and if they reflect current transactions and practices in the industry to which the asset belongs. These techniques include, where appropriate, applying multiples reflecting current market transactions to certain indicators driving the profitability of the asset (such as revenue, market shares, operating profit, etc.) or discounting estimated future net cash flows from the asset.

31. In accordance with this Standard:

(a) a transferee recognises an intangible asset that meets the recognition criteria in paragraphs 20 and 21, even if that intangible asset had not been recognised in the financial statements of the transferor; and

(b) if the cost (i.e. fair value) of an intangible asset acquired as part of an amalgamation in the nature of purchase cannot be measured reliably, that asset is not recognised as a separate intangible asset but is included in goodwill (see paragraph 55).

32. Unless there is an active market for an intangible asset acquired in an amalgamation in the nature of purchase, the cost initially recognised for the intangible asset is restricted to an amount that does not create or increase any capital reserve arising at the date of the amalgamation.

Acquisition by way of a Government Grant

33. In some cases, an intangible asset may be acquired free of charge, or for nominal consideration, by way of a government grant. This may occur when a government transfers or allocates to an enterprise intangible assets such as airport landing rights, licences to operate radio or television stations, import licences or quotas or rights to access other restricted resources. AS 12, Accounting for Government Grants, requires that government grants in the form of non-monetary assets, given at a concessional rate should be accounted for on the basis of their acquisition cost. AS 12 also requires that in case a non-monetary asset is given free of cost, it should be recorded at a nominal value. Accordingly, intangible asset acquired free of charge, or for nominal consideration, by way of government grant is recognised at a nominal value or at the acquisition cost, as appropriate; any expenditure that is directly attributable to making the asset ready for its intended use is also included in the cost of the asset.

Exchanges of Assets

34. An intangible asset may be acquired in exchange or part exchange for another asset. In such a case, the cost of the asset acquired is determined in accordance with the principles laid down in this regard in AS 10, Accounting for Fixed Assets.

Internally Generated Goodwill

35. Internally generated goodwill should not be recognised as an asset.

36. In some cases, expenditure is incurred to generate future economic benefits, but it does not result in the creation of an intangible asset that meets the recognition criteria in this Standard. Such expenditure is often described as contributing to internally generated goodwill. Internally generated goodwill is not recognised as an asset because it is not an identifiable resource controlled by the enterprise that can be measured reliably at cost.

37. Differences between the market value of an enterprise and the carrying amount of its identifiable net assets at any point in time may be due to a range of factors that affect the value of the enterprise. However, such differences cannot be considered to represent the cost of intangible assets controlled by the enterprise.

Internally Generated Intangible Assets

38. It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition. It is often difficult to:

(a) identify whether, and the point of time when, there is an identifiable asset that will generate probable future economic benefits; and

(b) determine the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the enterprise's internally generated goodwill or of running day-to- day operations.

Therefore, in addition to complying with the general requirements for the recognition and initial measurement of an intangible asset, an enterprise applies the requirements and guidance in paragraphs 39-54 below to all internally generated intangible assets.

39. To assess whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of the asset into:

(a) a research phase; and

(b) a development phase.

Although the terms 'research' and 'development' are defined, the terms 'research phase' and 'development phase' have a broader meaning for the purpose of this Standard.

40. If an enterprise cannot distinguish the research phase from the development phase of an internal project to create an intangible asset, the enterprise treats the expenditure on that project as if it were incurred in the research phase only.

Research Phase

41. No intangible asset arising from research (or from the research phase of an internal project) should be recognised. Expenditure on research (or on the research phase of an internal project) should be recognised as an expense when it is incurred.

42. This Standard takes the view that, in the research phase of a project, an enterprise cannot demonstrate that an intangible asset exists from which future economic benefits are probable. Therefore, this expenditure is recognised as an expense when it is incurred.

43. Examples of research activities are:

(a) activities aimed at obtaining new knowledge;

(b) the search for, evaluation and final selection of, applications of research findings or other knowledge;

(c) the search for alternatives for materials, devices, products, processes, systems or services; and

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

Development Phase

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

(a) the technical feasibility of completing the intangible asset so that it will be available for use or sale;

(b) its intention to complete the intangible asset and use or sell it;

(c) its ability to use or sell the intangible asset;

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

(e) the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and

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

45. In the development phase of a project, an enterprise can, in some instances, identify an intangible asset and demonstrate that future economic benefits from the asset are probable. This is because the development phase of a project is further advanced than the research phase.

46. Examples of development activities are:

(a) the design, construction and testing of pre-production or pre-use prototypes and models;

(b) the design of tools, jigs, moulds and dies involving new technology;

(c) the design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production; and

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

47. To demonstrate how an intangible asset will generate probable future economic benefits, an enterprise assesses the future economic benefits to be received from the asset using the principles in

Accounting Standard on Impairment of Assets[5]. If the asset will generate economic benefits only in combination with other assets, the enterprise applies the concept of cash- generating units as set out in Accounting Standard on Impairment of Assets.

48. Availability of resources to complete, use and obtain the benefits from an intangible asset can be demonstrated by, for example, a business plan showing the technical, financial and other resources needed and the enterprise's ability to secure those resources. In certain cases, an enterprise demonstrates the availability of external finance by obtaining a lender's indication of its willingness to fund the plan.

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

50. Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognised as intangible assets.

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

Cost of an Internally Generated Intangible Asset

52. The cost of an internally generated intangible asset for the purpose of paragraph 23 is the sum of expenditure incurred from the time when the intangible asset first meets the recognition criteria in paragraphs 20-21 and

44. Paragraph 58 prohibits reinstatement of expenditure recognised as an expense in previous annual financial statements or interim financial reports.

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

(a) expenditure on materials and services used or consumed in generating the intangible asset;

(b) the salaries, wages and other employment related costs of personnel directly engaged in generating the asset;

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

(d) overheads that are necessary to generate the asset and that can be allocated on a reasonable and consistent basis to the asset (for example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocations of overheads are made on bases similar to those used in allocating overheads to inventories (see AS 2, Valuation of Inventories). AS 16, Borrowing Costs, establishes criteria for the recognition of interest as a component of the cost of a qualifying asset. These criteria are also applied for the recognition of interest as a component of the cost of an internally generated intangible asset.

---

[5] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

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

(a) selling, administrative and other general overhead expenditure unless this expenditure can be directly attributed to making the asset ready for use;

(b) clearly identified inefficiencies and initial operating losses incurred before an asset achieves planned performance; and

(c) expenditure on training the staff to operate the asset.

Example Illustrating Paragraph 52

An enterprise is developing a new production process. During the year 20X1, expenditure incurred was ₹ 10 lakhs, of which ₹ 9 lakhs was incurred before 1 December 20X1 and 1 lakh was incurred between 1 December 20X1 and 31 December 20X1. The enterprise is able to demonstrate that, at 1 December 20X1, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 5 lakhs.

At the end of 20X1, the production process is recognised as an intangible asset at a cost of ₹ 1 lakh (expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X1). The ₹ 9 lakhs expenditure incurred before 1 December 20X1 is recognised as an expense because the recognition criteria were not met until 1 December 20X1. This expenditure will never form part of the cost of the production process recognised in the balance sheet.

During the year 20X2, expenditure incurred is ₹ 20 lakhs. At the end of 20X2, the recoverable amount of the know-how embodied in the process (including future cash outflows to complete the process before it is available for use) is estimated to be ₹ 19 lakhs.

At the end of the year 20X2, the cost of the production process is ₹ 21 lakhs (₹ 1 lakh expenditure recognised at the end of 20X1 plus ₹ 20 lakhs expenditure recognised in 20X2). The enterprise recognises an impairment loss of ₹ 2 lakhs to adjust the carrying amount of the process before impairment loss (₹ 21 lakhs) to its recoverable amount (₹ 19 lakhs). This impairment loss will be reversed in a subsequent period if the requirements for the reversal of an impairment loss in Accounting Standard on Impairment of Assets[6], are met.

Recognition of an Expense

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

(a) it forms part of the cost of an intangible asset that meets the recognition criteria (see paragraphs 19-54); or

(b) the item is acquired in an amalgamation in the nature of purchase and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of acquisition) should form part of the amount attributed to goodwill (capital reserve) at the date of acquisition (see AS 14, Accounting for Amalgamations).

56. In some cases, expenditure is incurred to provide future economic benefits to an enterprise, but no intangible asset or other asset is acquired or created that can be recognised. In these cases, the expenditure is recognised as an expense when it is incurred. For example, expenditure on research is

[6] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

always recognised as an expense when it is incurred (see paragraph 41). Examples of other expenditure that is recognised as an expense when it is incurred include:

(a) expenditure on start-up activities (start-up costs), unless this expenditure is included in the cost of an item of fixed asset under AS 10. Start-up costs may consist of preliminary expenses incurred in establishing a legal entity such as legal and secretarial costs, expenditure to open a new facility or business (pre-opening costs) or expenditures for commencing new operations or launching new products or processes (pre-operating costs);

(b) expenditure on training activities;

(c) expenditure on advertising and promotional activities; and

(d) expenditure on relocating or re-organising part or all of an enterprise.

57. Paragraph 55 does not apply to payments for the delivery of goods or services made in advance of the delivery of goods or the rendering of services. Such prepayments are recognised as assets.

Past Expenses not to be Recognised as an Asset

58. Expenditure on an intangible item that was initially recognised as an expense by a reporting enterprise in previous annual financial statements or interim financial reports should not be recognised as part of the cost of an intangible asset at a later date.

Subsequent Expenditure

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

(a) it is probable that the expenditure will enable the asset to generate future economic benefits in excess of its originally assessed standard of performance; and

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

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

60. Subsequent expenditure on a recognised intangible asset is recognised as an expense if this expenditure is required to maintain the asset at its originally assessed standard of performance. The nature of intangible assets is such that, in many cases, it is not possible to determine whether subsequent expenditure is likely to enhance or maintain the economic benefits that will flow to the enterprise from those assets. In addition, it is often difficult to attribute such expenditure directly to a particular intangible asset rather than the business as a whole. Therefore, only rarely will expenditure incurred after the initial recognition of a purchased intangible asset or after completion of an internally generated intangible asset result in additions to the cost of the intangible asset.

61. Consistent with paragraph 50, subsequent expenditure on brands, mastheads, publishing titles, customer lists and items similar in substance (whether externally purchased or internally generated) is always recognised as an expense to avoid the recognition of internally generated goodwill.

Measurement Subsequent to Initial Recognition

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

Amortisation

Amortisation Period

63. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. Amortisation should commence when the asset is available for use.

64. As the future economic benefits embodied in an intangible asset are consumed over time, the carrying amount of the asset is reduced to reflect that consumption. This is achieved by systematic allocation of the cost of the asset, less any residual value, as an expense over the asset's useful life. Amortisation is recognised whether or not there has been an increase in, for example, the asset's fair value or recoverable amount. Many factors need to be considered in determining the useful life of an intangible asset including:

(a) the expected usage of the asset by the enterprise and whether the asset could be efficiently managed by another management team;

(b) typical product life cycles for the asset and public information on estimates of useful lives of similar types of assets that are used in a similar way;

(c) technical, technological or other types of obsolescence;

(d) the stability of the industry in which the asset operates and changes in the market demand for the products or services output from the asset;

(e) expected actions by competitors or potential competitors;

(f) the level of maintenance expenditure required to obtain the expected future economic benefits from the asset and the company's ability and intent to reach such a level;

(g) the period of control over the asset and legal or similar limits on the use of the asset, such as the expiry dates of related leases; and

(h) whether the useful life of the asset is dependent on the useful life of other assets of the enterprise.

65. Given the history of rapid changes in technology, computer software and many other intangible assets are susceptible to technological obsolescence. Therefore, it is likely that their useful life will be short.

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

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

(a) amortises the intangible asset over the best estimate of its useful life;

(b) estimates the recoverable amount of the intangible asset at least annually in order to identify any impairment loss (see paragraph 83); and

(c) discloses the reasons why the presumption is rebutted and the factor(s) that played a significant role in determining the useful life of the asset (see paragraph 94(a)).

Examples

A. An enterprise has purchased an exclusive right to generate hydro-electric power for sixty years. The costs of generating hydro- electric power are much lower than the costs of obtaining power from alternative sources. It is expected that the geographical area surrounding the power station will demand a significant amount of power from the power station for at least sixty years.

The enterprise amortises the right to generate power over sixty years, unless there is evidence that its useful life is shorter.

B. An enterprise has purchased an exclusive right to operate a toll motorway for thirty years. There is no plan to construct alternative routes in the area served by the motorway. It is expected that this motorway will be in use for at least thirty years.

The enterprise amortises the right to operate the motorway over thirty years, unless there is evidence that its useful life is shorter.

68. The useful life of an intangible asset may be very long but it is always finite. Uncertainty justifies estimating the useful life of an intangible asset on a prudent basis, but it does not justify choosing a life that is unrealistically short.

69. If control over the future economic benefits from an intangible asset is achieved through legal rights that have been granted for a finite period, the useful life of the intangible asset should not exceed the period of the legal rights unless:

- ***(a) the legal rights are renewable; and***
- ***(b) renewal is virtually certain.***

70. There may be both economic and legal factors influencing the useful life of an intangible asset: economic factors determine the period over which future economic benefits will be generated; legal factors may restrict the period over which the enterprise controls access to these benefits. The useful life is the shorter of the periods determined by these factors.

71. The following factors, among others, indicate that renewal of a legal right is virtually certain:

- (a) the fair value of the intangible asset is not expected to reduce as the initial expiry date approaches, or is not expected to reduce by more than the cost of renewing the underlying right;
- (b) there is evidence (possibly based on past experience) that the legal rights will be renewed; and renewal of the legal right (if any) will be satisfied.
- (c) there is evidence that the conditions necessary to obtain the renewal of the legal right (if any) will be satisfied.

Amortisation Method

72. The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expense unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset.

73. A variety of amortisation methods can be used to allocate the depreciable amount of an asset on a systematic basis over its useful life. These methods include the straight-line method, the diminishing balance method and the unit of production method. The method used for an asset is selected based on the expected pattern of consumption of economic benefits and is consistently applied from period to

period, unless there is a change in the expected pattern of consumption of economic benefits to be derived from that asset. There will rarely, if ever, be persuasive evidence to support an amortisation method for intangible assets that results in a lower amount of accumulated amortisation than under the straight-line method.

74. Amortisation is usually recognised as an expense. However, sometimes, the economic benefits embodied in an asset are absorbed by the enterprise in producing other assets rather than giving rise to an expense. In these cases, the amortisation charge forms part of the cost of the other asset and is included in its carrying amount. For example, the amortisation of intangible assets used in a production process is included in the carrying amount of inventories (see AS 2, Valuation of Inventories).

Residual Value

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

- ***(a) there is a commitment by a third party to purchase the asset at the end of its useful life; or***
- ***(b) there is an active market for the asset and:***
  - ***(i) residual value can be determined by reference to that market; and***
  - ***(ii) it is probable that such a market will exist at the end of the asset's useful life.***

76. A residual value other than zero implies that an enterprise expects to dispose of the intangible asset before the end of its economic life.

77. The residual value is estimated using prices prevailing at the date of acquisition of the asset, for the sale of a similar asset that has reached the end of its estimated useful life and that has operated under conditions similar to those in which the asset will be used. The residual value is not subsequently increased for changes in prices or value.

Review of Amortisation Period and Amortisation Method

78. The amortisation period and the amortisation method should be reviewed at least at each financial year end. If the expected useful life of the asset is significantly different from previous estimates, the amortisation period should be changed accordingly. If there has been a significant change in the expected pattern of economic benefits from the asset, the amortisation method should be changed to reflect the changed pattern. Such changes should be accounted for in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

79. During the life of an intangible asset, it may become apparent that the estimate of its useful life is inappropriate. For example, the useful life may be extended by subsequent expenditure that improves the condition of the asset beyond its originally assessed standard of performance. Also, the recognition of an impairment loss may indicate that the amortisation period needs to be changed.

80. Over time, the pattern of future economic benefits expected to flow to an enterprise from an intangible asset may change. For example, it may become apparent that a diminishing balance method of amortisation is appropriate rather than a straight-line method. Another example is if use of the rights represented by a licence is deferred pending action on other components of the business plan. In this case, economic benefits that flow from the asset may not be received until later periods.

Recoverability of the Carrying Amount — Impairment Losses

81. To determine whether an intangible asset is impaired, an enterprise applies Accounting Standard on Impairment of Assets[7]. That Standard explains how an enterprise reviews the carrying amount of its assets, how it determines the recoverable amount of an asset and when it recognises or reverses an impairment loss.

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

83. In addition to the requirements of Accounting Standard on Impairment of Assets, an enterprise should estimate the recoverable amount of the following intangible assets at least at each financial year end even if there is no indication that the asset is impaired:

(a) an intangible asset that is not yet available for use; and

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

The recoverable amount should be determined under Accounting Standard on Impairment of Assets and impairment losses recognised accordingly.

84. The ability of an intangible asset to generate sufficient future economic benefits to recover its cost is usually subject to great uncertainty until the asset is available for use. Therefore, this Standard requires an enterprise to test for impairment, at least annually, the carrying amount of an intangible asset that is not yet available for use.

85. It is sometimes difficult to identify whether an intangible asset may be impaired because, among other things, there is not necessarily any obvious evidence of obsolescence. This difficulty arises particularly if the asset has a long useful life. As a consequence, this Standard requires, as a minimum, an annual calculation of the recoverable amount of an intangible asset if its useful life exceeds ten years from the date when it becomes available for use.

86. The requirement for an annual impairment test of an intangible asset applies whenever the current total estimated useful life of the asset exceeds ten years from when it became available for use. Therefore, if the useful life of an intangible asset was estimated to be less than ten years at initial recognition, but the useful life is extended by subsequent expenditure to exceed ten years from when the asset became available for use, an enterprise performs the impairment test required under paragraph 83(b) and also makes the disclosure required under paragraph 94(a).

Retirements and Disposals

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

---

[7] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

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

89. An intangible asset that is retired from active use and held for disposal is carried at its carrying amount at the date when the asset is retired from active use. At least at each financial year end, an enterprise tests the asset for impairment under Accounting Standard on Impairment of Assets[8], and recognises any impairment loss accordingly.

Disclosure

General

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

- ***(a) the useful lives or the amortisation rates used; (b) the amortisation methods used;***
- ***(c) the gross carrying amount and the accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;***
- ***(d) a reconciliation of the carrying amount at the beginning and end of the period showing:***
  - ***(i) additions, indicating separately those from internal development and through amalgamation;***
  - ***(ii) retirements and disposals;***
  - ***(iii) impairment losses recognised in the statement of profit and loss during the period (if any);***
  - ***(iv) impairment losses reversed in the statement of profit and loss during the period (if any);***
  - ***(v) amortisation recognised during the period; and***
  - ***(vi) other changes in the carrying amount during the period.***

91. A class of intangible assets is a grouping of assets of a similar nature and use in an enterprise's operations. Examples of separate classes may include:

- (a) brand names;
- (b) mastheads and publishing titles;
- (c) computer software;
- (d) licences and franchises;
- (e) .3copyrights, and patents and other industrial property rights, service and operating rights;
- (f) recipes, formulae, models, designs and prototypes; and
- (g) intangible assets under development.

---

[8] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

The classes mentioned above are disaggregated (aggregated) into smaller (larger) classes if this results in more relevant information for the users of the financial statements.

92. An enterprise discloses information on impaired intangible assets under Accounting Standard on Impairment of Assets[9] in addition to the information required by paragraph 90(d)(iii) and (iv).

93. An enterprise discloses the change in an accounting estimate or accounting policy such as that arising from changes in the amortisation method, the amortisation period or estimated residual values, in accordance with AS 5, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies.

94. The financial statements should also disclose:

- ***(a) if an intangible asset is amortised over more than ten years, the reasons why it is presumed that the useful life of an intangible asset will exceed ten years from the date when the asset is available for use. In giving these reasons, the enterprise should describe the factor(s) that played a significant role in determining the useful life of the asset;***
- ***(b) a description, the carrying amount and remaining amortisation period of any individual intangible asset that is material to the financial statements of the enterprise as a whole;***
- ***(c) the existence and carrying amounts of intangible assets whose title is restricted and the carrying amounts of intangible assets pledged as security for liabilities; and***
- ***(d) the amount of commitments for the acquisition of intangible assets.***

95. When an enterprise describes the factor(s) that played a significant role in determining the useful life of an intangible asset that is amortised over more than ten years, the enterprise considers the list of factors in paragraph 64.

Research and Development Expenditure

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

97. Research and development expenditure comprises all expenditure that is directly attributable to research or development activities or that can be allocated on a reasonable and consistent basis to such activities (see paragraphs 53-54 for guidance on the type of expenditure to be included for the purpose of the disclosure requirement in paragraph 96).

Other Information

98. An enterprise is encouraged, but not required, to give a description of any fully amortised intangible asset that is still in use.

Transitional Provisions

99. Where, on the date of this Standard coming into effect, an enterprise is following an accounting policy of not amortising an intangible item or amortising an intangible item over a period longer than the period determined under paragraph 63 of this Standard and the period determined under paragraph 63 has expired on the date of this Standard coming into effect, the

[9] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

carrying amount appearing in the balance sheet in respect of that item should be eliminated with a corresponding adjustment to the opening balance of revenue reserves.

In the event the period determined under paragraph 63 has not expired on the date of this Standard coming into effect and:

(a) if the enterprise is following an accounting policy of not amortising an intangible item, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

(b) if the remaining period as per the accounting policy followed by the enterprise:

(i) is shorter as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be amortised over the remaining period as per the accounting policy followed by the enterprise,

(ii) is longer as compared to the balance of the period determined under paragraph 63, the carrying amount of the intangible item should be restated, as if the accumulated amortisation had always been determined under this Standard, with the corresponding adjustment to the opening balance of revenue reserves. The restated carrying amount should be amortised over the balance of the period as determined in paragraph 63.

100. Illustration B attached to the Standard illustrates the application of paragraph 99.

Illustration A

This illustration which does not form part of the Accounting Standard, provides illustrative application of the principles laid down in the Standard to internal use software and web-site costs. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

I. Illustrative Application of the Accounting

Standard to Internal Use Computer Software

Computer software for internal use can be internally generated or acquired.

Internally Generated Computer Software

1. Internally generated computer software for internal use is developed or modified internally by the enterprise solely to meet the needs of the enterprise and at no stage it is planned to sell it.

2. The stages of development of internally generated software may be categorised into the following two phases:

- Preliminary project stage, i.e., the research phase
- Development stage

Preliminary project stage

3. At the preliminary project stage the internally generated software should not be recognised as an asset. Expenditure incurred in the preliminary project stage should be recognised as an expense when it is incurred. The reason for such a treatment is that at this stage of the software project an enterprise can not demonstrate that an asset exists from which future economic benefits are probable.

4. When a computer software project is in the preliminary project stage, enterprises are likely to:

   (a) Make strategic decisions to allocate resources between alternative projects at a given point in time. For example, should programmers develop a new payroll system or direct their efforts toward correcting existing problems in an operating payroll system.

   (b) Determine the performance requirements (that is, what it is that they need the software to do) and systems requirements for the computer software project it has proposed to undertake.

   (c) Explore alternative means of achieving specified performance requirements. For example, should an entity make or buy the software. Should the software run on a mainframe or a client server system.

   (d) Determine that the technology needed to achieve performance requirements exists.

   (e) Select a consultant to assist in the development and/or installation of the software.

Development Stage

5. An internally generated software arising at the development stage should be recognised as an asset if, and only if, an enterprise can demonstrate all of the following:

   (a) the technical feasibility of completing the internally generated software so that it will be available for internal use;

   (b) the intention of the enterprise to complete the internally generated software and use it to perform the functions intended. For example, the intention to complete the internally generated software can be demonstrated if the enterprise commits to the funding of the software project;

   (c) the ability of the enterprise to use the software;

   (d) how the software will generate probable future economic benefits. Among other things, the enterprise should demonstrate the usefulness of the software;

   (e) the availability of adequate technical, financial and other resources to complete the development and to use the software; and

   (f) the ability of the enterprise to measure the expenditure attributable to the software during its development reliably.

6. Examples of development activities in respect of internally generated software include:

   (a) Design including detailed program design - which is the process of detail design of computer software that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding.

   (b) Coding which includes generating detailed instructions in a computer language to carry out the requirements described in the detail program design. The coding of computer software may begin prior to, concurrent with, or subsequent to the completion of the detail program design.

At the end of these stages of the development activity, the enterprise has a working model, which is an operative version of the computer software capable of performing all the major planned functions, and is ready for initial testing ("beta" versions).

   (c) Testing which is the process of performing the steps necessary to determine whether the coded computer software product meets function, feature, and technical performance requirements set forth in the product design.

At the end of the testing process, the enterprise has a master version of the internal use software, which is a completed version together with the related user documentation and the training materials.

Cost of internally generated software

7. The cost of an internally generated software is the sum of the expenditure incurred from the time when the software first met the recognition criteria for an intangible asset as stated in paragraphs 20 and 21 of this Standard and paragraph 5 above. An expenditure which did not meet the recognition criteria as aforesaid and expensed in an earlier financial statements should not be reinstated if the recognition criteria are met later.

8. The cost of an internally generated software comprises all expenditure that can be directly attributed or allocated on a reasonable and consistent basis to create the software for its intended use. The cost include:

(a) expenditure on materials and services used or consumed in developing the software;

(b) the salaries, wages and other employment related costs of personnel directly engaged in developing the software;

(c) any expenditure that is directly attributable to generating software; and

(d) overheads that are necessary to generate the software and that can be allocated on a reasonable and consistent basis to the software (For example, an allocation of the depreciation of fixed assets, insurance premium and rent). Allocation of overheads are made on basis similar to those used in allocating the overhead to inventories.

9. The following are not components of the cost of an internally generated software:

(a) selling, administration and other general overhead expenditure unless this expenditure can be directly attributable to the development of the software;

(b) clearly identified inefficiencies and initial operating losses incurred before software achieves the planned performance; and

(c) expenditure on training the staff to use the internally generated software.

Software Acquired for Internal Use

10. The cost of a software acquired for internal use should be recognised as an asset if it meets the recognition criteria prescribed in paragraphs 20 and 21 of this Standard.

11. The cost of a software purchased for internal use comprises its purchase price, including any import duties and other taxes (other than those subsequently recoverable by the enterprise from the taxing authorities) and any directly attributable expenditure on making the software ready for its use. Any trade discounts and rebates are deducted in arriving at the cost. In the determination of cost, matters stated in paragraphs 24 to 34 of the Standard need to be considered, as appropriate.

Subsequent expenditure

12. Enterprises may incur considerable cost in modifying existing software systems. Subsequent expenditure on software after its purchase or its completion should be recognised as an expense when it is incurred unless:

(a) it is probable that the expenditure will enable the software to generate future economic benefits in excess of its originally assessed standards of performance; and

(b) the expenditure can be measured and attributed to the software reliably.

If these conditions are met, the subsequent expenditure should be added to the carrying amount of the software. Costs incurred in order to restore or maintain the future economic benefits that an enterprise can expect from the originally assessed standard of performance of existing software systems is recognised as an expense when, and only when, the restoration or maintenance work is carried out.

Amortisation period

13. The depreciable amount of a software should be allocated on a systematic basis over the best estimate of its useful life. The amortisation should commence when the software is available for use.

14. As per this Standard, there is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. However, given the history of rapid changes in technology, computer software is susceptible to technological obsolescence. Therefore, it is likely that useful life of the software will be much shorter, say 3 to 5 years.

Amortisation method

15. The amortisation method used should reflect the pattern in which the software's economic benefits are consumed by the enterprise. If that pattern can not be determined reliably, the straight-line method should be used. The amortisation charge for each period should be recognised as an expenditure unless another Accounting Standard permits or requires it to be included in the carrying amount of another asset. For example, the amortisation of a software used in a production process is included in the carrying amount of inventories.

II. Illustrative Application of the Accounting Standard to Web-Site Costs

1. An enterprise may incur internal expenditures when developing, enhancing and maintaining its own web site. The web site may be used for various purposes such as promoting and advertising products and services, providing electronic services, and selling products and services.

2. The stages of a web site's development can be described as follows:

   (a) Planning - includes undertaking feasibility studies, defining objectives and specifications, evaluating alternatives and selecting preferences;

   (b) Application and Infrastructure Development - includes obtaining a domain name, purchasing and developing hardware and operating software, installing developed applications and stress testing; and

   (c) Graphical Design and Content Development - includes designing the appearance of web pages and creating, purchasing, preparing and uploading information, either textual or graphical in nature, on the web site prior to the web site becoming available for use. This information may either be stored in separate databases that are integrated into (or accessed from) the web site or coded directly into the web pages.

3. Once development of a web site has been completed and the web site is available for use, the web site commences an operating stage. During this stage, an enterprise maintains and enhances the applications, infrastructure, graphical design and content of the web site.

4. The expenditures for purchasing, developing, maintaining and enhancing hardware (e.g., web servers, staging servers, production servers and Internet connections) related to a web site are not accounted for under this Standard but are accounted for under AS 10, Accounting for Fixed Assets. Additionally, when an enterprise incurs an expenditure for having an Internet service provider host the

enterprise's web site on it's own servers connected to the Internet, the expenditure is recognised as an expense.

5. An intangible asset is defined in paragraph 6 of this Standard as an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, for rental to others, or for administrative purposes. Paragraph 7 of this Standard provides computer software as a common example of an intangible asset. By analogy, a web site is another example of an intangible asset. Accordingly, a web site developed by an enterprise for its own use is an internally generated intangible asset that is subject to the requirements of this Standard.

6. An enterprise should apply the requirements of this Standard to an internal expenditure for developing, enhancing and maintaining its own web site. Paragraph 55 of this Standard provides expenditure on an intangible item to be recognised as an expense when incurred unless it forms part of the cost of an intangible asset that meets the recognition criteria in paragraphs 19-54 of the Standard. Paragraph 56 of the Standard requires expenditure on start-up activities to be recognised as an expense when incurred. Developing a web site by an enterprise for its own use is not a start-up activity to the extent that an internally generated intangible asset is created. An enterprise applies the requirements and guidance in paragraphs 39-54 of this Standard to an expenditure incurred for developing its own web site in addition to the general requirements for recognition and initial measurement of an intangible asset. The cost of a web site, as described in paragraphs 52-54 of this Standard, comprises all expenditure that can be directly attributed, or allocated on a reasonable and consistent basis, to creating, producing and preparing the asset for its intended use.

The enterprise should evaluate the nature of each activity for which an expenditure is incurred (e.g., training employees and maintaining the web site) and the web site's stage of development or post-development:

(a) Paragraph 41 of this Standard requires an expenditure on research (or on the research phase of an internal project) to be recognised as an expense when incurred. The examples provided in paragraph 43 of this Standard are similar to the activities undertaken in the Planning stage of a web site's development. Consequently, expenditures incurred in the Planning stage of a web site's development are recognised as an expense when incurred.

(b) Paragraph 44 of this Standard requires an intangible asset arising from the development phase of an internal project to be recognised if an enterprise can demonstrate fulfillment of the six criteria specified. Application and Infrastructure Development and Graphical Design and Content Development stages are similar in nature to the development phase. Therefore, expenditures incurred in these stages should be recognised as an intangible asset if, and only if, in addition to complying with the general requirements for recognition and initial measurement of an intangible asset, an enterprise can demonstrate those items described in paragraph 44 of this Standard. In addition,

    (i) an enterprise may be able to demonstrate how its web site will generate probable future economic benefits under paragraph 44(d) by using the principles in Accounting Standard on Impairment of Assets[10]. This includes situations where the web site is developed solely or primarily for promoting and advertising an enterprise's own products and services. Demonstrating how a web site will generate probable future economic benefits under paragraph 44(d) by assessing the economic benefits to be

[10] Accounting Standard (AS) 28, 'Impairment of Assets', specifies the requirements relating to impairment of assets.

received from the web site and using the principles in Accounting Standard on Impairment of Assets, may be particularly difficult for an enterprise that develops a web site solely or primarily for advertising and promoting its own products and services; information is unlikely to be available for reliably estimating the amount obtainable from the sale of the web site in an arm's length transaction, or the future cash inflows and outflows to be derived from its continuing use and ultimate disposal. In this circumstance, an enterprise determines the future economic benefits of the cash-generating unit to which the web site belongs, if it does not belong to one. If the web site is considered a corporate asset (one that does not generate cash inflows independently from other assets and their carrying amount cannot be fully attributed to a cash- generating unit), then an enterprise applies the 'bottom-up' test and/or the 'top-down' test under Accounting Standard on Impairment of Assets.

(ii) an enterprise may incur an expenditure to enable use of content, which had been purchased or created for another purpose, on its web site (e.g., acquiring a license to reproduce information) or may purchase or create content specifically for use on its web site prior to the web site becoming available for use. In such circumstances, an enterprise should determine whether a separate asset, is identifiable with respect to such content (e.g., copyrights and licenses), and if a separate asset is not identifiable, then the expenditure should be included in the cost of developing the web site when the expenditure meets the conditions in paragraph 44 of this Standard. As per paragraph 20 of this Standard, an intangible asset is recognised if, and only if, it meets specified criteria, including the definition of an intangible asset. Paragraph 52 indicates that the cost of an internally generated intangible asset is the sum of expenditure incurred from the time when the intangible asset first meets the specified recognition criteria. When an enterprise acquires or creates content, it may be possible to identify an intangible asset (e.g., a license or a copyright) separate from a web site. Consequently, an enterprise determines whether an expenditure to enable use of content, which had been created for another purpose, on its web site becoming available for use results in a separate identifiable asset or the expenditure is included in the cost of developing the web site.

(c) the operating stage commences once the web site is available for use, and therefore an expenditure to maintain or enhance the web site after development has been completed should be recognised as an expense when it is incurred unless it meets the criteria in paragraph 59 of the Standard. Paragraph 60 explains that if the expenditure is required to maintain the asset at its originally assessed standard of performance, then the expenditure is recognised as an expense when incurred.

7. An intangible asset is measured subsequent to initial recognition by applying the requirements in paragraph 62 of this Standard. Additionally, since paragraph 68 of the Standard states that an intangible asset always has a finite useful life, a web site that is recognised as an asset is amortised over the best estimate of its useful life. As indicated in paragraph 65 of the Standard, web sites are susceptible to technological obsolescence, and given the history of rapid changes in technology, their useful life will be short.

8. The following table illustrates examples of expenditures that occur within each of the stages described in paragraphs 2 and 3 above and application of paragraphs 5 and 6 above. It is not intended to be a comprehensive checklist of expenditures that might be incurred.

Nature of Expenditure	Accounting treatment
Planning • undertaking feasibility studies • defining hardware and software specifications • evaluating alternative products and suppliers • selecting preferences	Expense when incurred
Application and Infrastructure Development • purchasing or developing hardware	Apply the requirements of AS 10
• obtaining a domain name • developing operating software (e.g., operating system and server software) • developing code for the application • installing developed applications on the web server • stress testing	Expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Graphical Design and Content Development • designing the appearance (e.g., layout and colour) of web pages • creating, purchasing, preparing (e.g., creating links and identifying tags), and uploading information, either textual or graphical in nature, on the website prior to the web site becoming available for use. Examples of content include information about an enterprise, products or services offered for sale, and topics that subscribers access	If a separate asset is not identifiable, then expense when incurred, unless it meets the recognition criteria under paragraphs 20 and 44
Operating • updating graphics and revising content • adding new functions, features and content • registering the web site with search engines • backing up data • reviewing security access • analysing usage of the web site	Expense when incurred, unless in rare circumstances it meets the criteria in paragraph 59, in which case the expenditure is included in the cost of the web site

Other • selling, administrative and other general overhead expenditure unless it can be directly attributed to preparing the web site for use • clearly identified inefficiencies • and initial operating losses incurred before the web site achieves planned performance (e.g., false start testing) • training employees to operate the web site	Expense when incurred

Illustration B

This Illustration which does not form part of the Accounting Standard, provides illustrative application of the requirements contained in paragraph 99 of this Accounting Standard in respect of transitional provisions.

Illustration 1 - Intangible Item was not amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 10 lakhs as on 1-4-2003. The item was acquired for ₹ 10 lakhs on April 1, 1990 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1990.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of the intangible item of ₹ 10 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustration 2 - Intangible Item is being amortised and the amortisation period determined under paragraph 63 has expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 8 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 1991 and was available for use from that date. The enterprise has been following a policy of amortising the item over a period of 20 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years from the date when the item was available for use i.e., April 1, 1991.

Since the amortisation period determined by applying paragraph 63 has already expired as on 1-4-2003, the carrying amount of ₹ 8 lakhs would be required to be eliminated with a corresponding adjustment to the opening balance of revenue reserves as on 1-4-2003.

Illustration 3 - Amortisation period determined under paragraph63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is shorter.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 8 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 5 years on straight line basis. Applying paragraph 63, the enterprise determines the amortisation period to be 8 years, being the best estimate of its useful life, from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 2 years as per the accounting policy followed by the enterprise which is shorter as compared to the balance of amortisation period determined by applying paragraph 63, i.e., 5 years. Accordingly, the enterprise would be required to amortise the intangible item over the remaining 2 years as per the accounting policy followed by the enterprise.

Illustration 4 - Amortisation period determined under paragraph 63 has not expired and the remaining amortisation period as per the accounting policy followed by the enterprise is longer.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 18 lakhs as on 1-4-2003. The item was acquired for ₹ 24 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following a policy of amortising the intangible item over a period of 12 years on straight-line basis. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the remaining period of amortisation is 9 years as per the accounting policy followed by the enterprise which is longer as compared to the balance of period stipulated in paragraph 63, i.e., 7 years. Accordingly, the enterprise would be required to restate the carrying amount of intangible item on 1-4-2003 at ₹ 16.8 lakhs (₹ 24 lakhs - 3x₹ 2.4 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of ₹ 1.2 lakhs (₹ 18 lakhs-₹ 16.8 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of ₹ 16.8 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

Illustration 5 - Intangible Item is not amortised and amortisation period determined under paragraph 63 has not expired.

An intangible item is appearing in the balance sheet of A Ltd. at ₹ 20 lakhs as on 1-4-2003. The item was acquired for ₹ 20 lakhs on April 1, 2000 and was available for use from that date. The enterprise has been following an accounting policy of not amortising the item. Applying paragraph 63, the enterprise determines that the item would have been amortised over a period of 10 years on straight line basis from the date when the item was available for use i.e., April 1, 2000.

On 1-4-2003, the enterprise would be required to restate the carrying amount of intangible item at ₹ 14 lakhs (₹ 20 lakhs - 3x₹ 2 lakhs, i.e., amortisation that would have been charged as per the Standard) and the difference of ₹ 6 lakhs (₹ 20 lakhs-₹ 14 lakhs) would be required to be adjusted against the opening balance of the revenue reserves. The carrying amount of ₹ 14 lakhs would be amortised over 7 years which is the balance of the amortisation period as per paragraph 63.

AS 29[*] : Provisions, Contingent Liabilities and Contingent Assets

*[This Accounting Standard includes paragraphs set in **bold italic** type and plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of its objective, the Preface to the Statements of Accounting Standards[1] and the 'Applicability of Accounting Standards to Various Entities'.]*

---

[*] Issued in 2003.

[1] Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

Pursuant to this Accounting Standard coming into effect, all paragraphs of Accounting Standards (AS) 4, Contingencies and Events Occurring After the Balance Sheet Date, that deal with contingencies (viz., paragraphs 1(a), 2, 3.1, 4 (4.1 to 4.4), 5(5.1 to 5.6), 6, 7 (7.1 to 7.3), 9.1 (relevant partion). 9.2, 10, 11, 12 and 16), stand withdrawn except to the extent they deal with impairment of assets not covered by other Accounting Standards.

Objective

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

Scope

1. 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[2] that are carried at fair value;

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

Explanation:

(i) An 'onerous contract' is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. Thus, for a contract to qualify as an onerous contract, the unavoidable costs of meeting the obligation under the contract should exceed the economic benefits expected to be received under it. The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfill it.

(ii) If an enterprise has a contract that is onerous, the present obligation under the contract is recognised and measured as a provision as per this Standard.

The application of the above explanation is illustrated in Illustration 10 of Illustration C attached to the Standard.

(c) those arising in insurance enterprises from contracts with policy-holders; and

(d) those covered by another Accounting Standard.

2. This Standard applies to financial instruments (including guarantees) that are not carried at fair value.

3. Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. This Standard does not apply to executory contracts unless they are onerous.

4. This Standard applies to provisions, contingent liabilities and contingent assets of insurance enterprises other than those arising from contracts with policy-holders.

---

[2] For the purpose of this Standard, the term 'financial instruments' shall have the same meaning as in Accounting Standard (AS) 20, Earnings Per Share.

5. Where another Accounting Standard deals with a specific type of provision, contingent liability or contingent asset, an enterprise applies that Standard instead of this Standard. For example, certain types of provisions are also addressed in Accounting Standards on:

(a) construction contracts (see AS 7, Construction Contracts);

(b) taxes on income (see AS 22, Accounting for Taxes on Income);

(c) leases (see AS 19, Leases). However, as AS 19 contains no specific requirements to deal with operating leases that have become onerous, this Standard applies to such cases; and

(d) retirement benefits (see AS 15, Accounting for Retirement Benefits in the Financial Statements of Employers).[3]

6. Some amounts treated as provisions may relate to the recognition of revenue, for example where an enterprise gives guarantees in exchange for a fee. This Standard 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 Standard does not change the requirements of AS 9.

7. This Standard 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 Standard.

8. Other Accounting Standards specify whether expenditures are treated as assets or as expenses. These issues are not addressed in this Standard. Accordingly, this Standard neither prohibits nor requires capitalisation of the costs recognised when a provision is made.

9. This Standard applies to provisions for restructuring (including discontinuing operations). Where a restructuring meets the definition of a discontinuing operation, additional disclosures are required by AS 24, Discontinuing Operations.

Definitions

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

10.1 A provision is a liability which can be measured only by using a substantial degree of estimation.

10.2 A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

10.3 An obligating event is an event that creates an obligation that results in an enterprise having no realistic alternative to settling that obligation.

10.4 A contingent liability is:

(a) a possible obligation that arises from past events and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or

[3] AS 15 (issued 1995) has since been revised and is now titled as 'Employee Benefits'.

(b) a present obligation that arises from past events but is not recognised because:

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

(ii) a reliable estimate of the amount of the obligation cannot be made.

10.5 A contingent asset is a possible asset that arises from past events the existence of which will be confirmed only by the occurrence or non- occurrence of one or more uncertain future events not wholly within the control of the enterprise.

10.6 Present obligation - an obligation is a present obligation if, based on the evidence available, its existence at the balance sheet date is considered probable, i.e., more likely than not.

10.7 Possible obligation - an obligation is a possible obligation if, based on the evidence available, its existence at the balance sheet date is considered not probable.

10.8 A restructuring is a programme that is planned and controlled by management, and materially changes either:

(a) the scope of a business undertaken by an enterprise; or

(b) the manner in which that business is conducted.

11. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. Obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

12. Provisions can be distinguished from other liabilities such as trade payables and accruals because in the measurement of provisions substantial degree of estimation is involved with regard to the future expenditure required in settlement. By contrast:

(a) trade payables are liabilities to pay for goods or services that have been received or supplied and have been invoiced or formally agreed with the supplier; and

(b) accruals are liabilities to pay for goods or services that have been received or supplied but have not been paid, invoiced or formally agreed with the supplier, including amounts due to employees. Although it is sometimes necessary to estimate the amount of accruals, the degree of estimation is generally much less than that for provisions.

13. In this Standard, the term ‘contingent’ is used for liabilities and assets that are not recognised because their existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise. In addition, the term ‘contingent liability’ is used for liabilities that do not meet the recognition criteria.

Recognition

Provisions

14. A provision should be recognised when:

(a) an enterprise has a present obligation as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision should be recognised.

Present Obligation

15. In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in a present obligation. In such a case, an enterprise determines whether a present obligation exists at the balance sheet date by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the balance sheet date. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the balance sheet date, the enterprise recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the balance sheet date, the enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

Past Event

16. A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the enterprise has no realistic alternative to settling the obligation created by the event.

17. Financial statements deal with the financial position of an enterprise at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised in an enterprise's balance sheet are those that exist at the balance sheet date.

18. It is only those obligations arising from past events existing independently of an enterprise's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the enterprise. Similarly, an enterprise recognises a provision for the decommissioning costs of an oil installation to the extent that the enterprise is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an enterprise may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the enterprise can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

19. An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large.

20. An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will become an obligating event when a new law requires the existing damage to be rectified.

21. Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted. Differences in circumstances surrounding enactment usually make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

Probable Outflow of Resources Embodying Economic Benefits

22. For a liability to qualify for recognition there must be not only a present obligation but also the probability of an outflow of resources embodying economic benefits to settle that obligation. For the purpose of this Standard[4], an outflow of resources or other event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not. Where it is not probable that a present obligation exists, an enterprise discloses a contingent liability, unless the possibility of an outflow of resources embodying economic benefits is remote (see paragraph 68).

23. Where there are a number of similar obligations (e.g. product warranties or similar contracts) the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised (if the other recognition criteria are met).

Reliable Estimate of the Obligation

24. The use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability. This is especially true in the case of provisions, which by their nature involve a greater degree of estimation than most other items. Except in extremely rare cases, an enterprise will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is reliable to use in recognising a provision.

25. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a contingent liability (see paragraph 68).

Contingent Liabilities

26. An enterprise should not recognise a contingent liability.

27. A contingent liability is disclosed, as required by paragraph 68, unless the possibility of an outflow of resources embodying economic benefits is remote.

28. Where an enterprise is jointly and severally liable for an obligation, the part of the obligation that is expected to be met by other parties is treated as a contingent liability. The enterprise recognises a provision for the part of the obligation for which an outflow of resources embodying economic benefits is probable, except in the extremely rare circumstances where no reliable estimate can be made (see paragraph 14).

29. Contingent liabilities may develop in a way not initially expected. Therefore, they are assessed continually to determine whether an outflow of resources embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in accordance with paragraph 14 in the financial statements of the period in which the change in probability occurs (except in the extremely rare circumstances where no reliable estimate can be made).

Contingent Assets

30. An enterprise should not recognise a contingent asset.

---

[4] The interpretation of 'probable' in this Standard as 'more likely than not' does not necessarily apply in other Accounting Standards.

31. Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the enterprise. An example is a claim that an enterprise is pursuing through legal processes, where the outcome is uncertain.

32. Contingent assets are not recognised in financial statements since this may result in the recognition of income that may never be realised. However, when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate.

33. A contingent asset is not disclosed in the financial statements. It is usually disclosed in the report of the approving authority (Board of Directors in the case of a company, and, the corresponding approving authority in the case of any other enterprise), where an inflow of economic benefits is probable.

34. Contingent assets are assessed continually and if it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognised in the financial statements of the period in which the change occurs.

Measurement

Best Estimate

35. The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the balance sheet date. The amount of a provision should not be discounted to its present value.

36. The estimates of outcome and financial effect are determined by the judgment of the management of the enterprise, supplemented by experience of similar transactions and, in some cases, reports from independent experts. The evidence considered includes any additional evidence provided by events after the balance sheet date.

37. The provision is measured before tax; the tax consequences of the provision, and changes in it, are dealt with under AS 22, Accounting for Taxes on Income.

Risks and Uncertainties

38. The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision.

39. Risk describes variability of outcome. A risk adjustment may increase the amount at which a liability is measured. Caution is needed in making judgments under conditions of uncertainty, so that income or assets are not overstated and expenses or liabilities are not understated. However, uncertainty does not justify the creation of excessive provisions or a deliberate overstatement of liabilities. For example, if the projected costs of a particularly adverse outcome are estimated on a prudent basis, that outcome is not then deliberately treated as more probable than is realistically the case. Care is needed to avoid duplicating adjustments for risk and uncertainty with consequent overstatement of a provision.

40. Disclosure of the uncertainties surrounding the amount of the expenditure is made under paragraph 67(b).

Future Events

41. Future events that may affect the amount required to settle an obligation should be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.

42. Expected future events may be particularly important in measuring provisions. For example, an enterprise may believe that the cost of cleaning up a site at the end of its life will be reduced by future changes in technology. The amount recognised reflects a reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. Thus, it is appropriate to include, for example, expected cost reductions associated with increased experience in applying existing technology or the expected cost of applying existing technology to a larger or more complex clean-up operation than has previously been carried out. However, an enterprise does not anticipate the development of a completely new technology for cleaning up unless it is supported by sufficient objective evidence.

43. The effect of possible new legislation is taken into consideration in measuring an existing obligation when sufficient objective evidence exists that the legislation is virtually certain to be enacted. The variety of circumstances that arise in practice usually makes it impossible to specify a single event that will provide sufficient, objective evidence in every case. Evidence is required both of what legislation will demand and of whether it is virtually certain to be enacted and implemented in due course. In many cases sufficient objective evidence will not exist until the new legislation is enacted.

Expected Disposal of Assets

44. Gains from the expected disposal of assets should not be taken into account in measuring a provision.

45. Gains on the expected disposal of assets are not taken into account in measuring a provision, even if the expected disposal is closely linked to the event giving rise to the provision. Instead, an enterprise recognises gains on expected disposals of assets at the time specified by the Accounting Standard dealing with the assets concerned.

Reimbursements

46. Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement should be recognised when, and only when, it is virtually certain that reimbursement will be received if the enterprise settles the obligation. The reimbursement should be treated as a separate asset. The amount recognised for the reimbursement should not exceed the amount of the provision.

47. In the statement of profit and loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.

48. Sometimes, an enterprise is able to look to another party to pay part or all of the expenditure required to settle a provision (for example, through insurance contracts, indemnity clauses or suppliers' warranties). The other party may either reimburse amounts paid by the enterprise or pay the amounts directly.

49. In most cases, the enterprise will remain liable for the whole of the amount in question so that the enterprise would have to settle the full amount if the third party failed to pay for any reason. In this situation, a provision is recognised for the full amount of the liability, and a separate asset for the expected reimbursement is recognised when it is virtually certain that reimbursement will be received if the enterprise settles the liability.

50. In some cases, the enterprise will not be liable for the costs in question if the third party fails to pay. In such a case, the enterprise has no liability for those costs and they are not included in the provision.

51. As noted in paragraph 28, an obligation for which an enterprise is jointly and severally liable is a contingent liability to the extent that it is expected that the obligation will be settled by the other parties.

Changes in Provisions

52. Provisions should be reviewed at each balance sheet date and adjusted to reflect the current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed.

Use of Provisions

53. A provision should be used only for expenditures for which the provision was originally recognised.

54. Only expenditures that relate to the original provision are adjusted against it. Adjusting expenditures against a provision that was originally recognised for another purpose would conceal the impact of two different events.

Application of the Recognition and Measurement Rules

Future Operating Losses

55. Provisions should not be recognised for future operating losses.

56. Future operating losses do not meet the definition of a liability in paragraph 10 and the general recognition criteria set out for provisions in paragraph 14.

57. An expectation of future operating losses is an indication that certain assets of the operation may be impaired. An enterprise tests these assets for impairment under Accounting Standard (AS) 28, Impairment of Assets.

Restructuring

58. The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental re-organisations that have a material effect on the nature and focus of the enterprise's operations.

59. A provision for restructuring costs is recognised only when the recognition criteria for provisions set out in paragraph 14 are met.

60. No obligation arises for the sale of an operation until the enterprise is committed to the sale, i.e., there is a binding sale agreement.

61. An enterprise cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the enterprise will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment under Accounting Standard (AS) 28, Impairment of Assets.

62. A restructuring provision should include only the direct expenditures arising from the restructuring which are those that are both:

(a) necessarily entailed by the restructuring; and

(b) not associated with the ongoing activities of the enterprise.

63. A restructuring provision does not include such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business and are not liabilities for restructuring at the balance sheet date. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

64. Identifiable future operating losses up to the date of a restructuring are not included in a provision.

65. As required by paragraph 44, gains on the expected disposal of assets are not taken into account in measuring a restructuring provision, even if the sale of assets is envisaged as part of the restructuring.

Disclosure

66. For each class of provision, an enterprise should disclose:

(a) the carrying amount at the beginning and end of the period; (b) additional provisions made in the period, including increases to existing provisions;

(c) amounts used (i.e. incurred and charged against the provision) during the period; and

(d) unused amounts reversed during the period.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities), may not comply with paragraph 66 above.

67. An enterprise should disclose the following for each class of provision:

(a) a brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits;

(b) an indication of the uncertainties about those outflows. Where necessary to provide adequate information, an enterprise should disclose the major assumptions made concerning future events, as addressed in paragraph 41; and

(c) the amount of any expected reimbursement, stating the amount of any asset that has been recognised for that expected reimbursement.

Provided that a Small and Medium-sized Company and a Small and Medium-sized Enterprise (Level II and Level III non-corporate entities may not comply with paragraph 67 above.

68. Unless the possibility of any outflow in settlement is remote, an enterprise should disclose for each class of contingent liability at the balance sheet date a brief description of the nature of the contingent liability and, where practicable:

(a) an estimate of its financial effect, measured under paragraphs 35-45;

(b) an indication of the uncertainties relating to any outflow; and

(c) the possibility of any reimbursement.

69. In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfill the requirements of paragraphs 67 (a) and (b) and 68 (a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products,

but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.

70. Where a provision and a contingent liability arise from the same set of circumstances, an enterprise makes the disclosures required by paragraphs 66-68 in a way that shows the link between the provision and the contingent liability.

71. Where any of the information required by paragraph 68 is not disclosed because it is not practicable to do so, that fact should be stated.

72. In extremely rare cases, disclosure of some or all of the information required by paragraphs 66-70 can be expected to prejudice seriously the position of the enterprise in a dispute with other parties on the subject matter of the provision or contingent liability. In such cases, an enterprise need not disclose the information, but should disclose the general nature of the dispute, together with the fact that, and reason why, the information has not been disclosed.

Illustration A

Tables - Provisions, Contingent Liabilities and Reimbursements

The purpose of this illustration is to summarise the main requirements of the Accounting Standard. It does not form part of the Accounting Standard and should be read in the context of the full text of the Ac- counting Standard.

Provisions and Contingent Liabilities

Where, as a result of past events, there may be an outflow of resources embodying future economic benefits in settlement of: (a) a present obligation the one whose existence at the balance sheet date is considered probable; or (b) a possible obligation the existence of which at the balance sheet date is considered not probable.		
There is a present obligation that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation.	**There is a possible obligation or a present obligation that may, but probably will not, require an outflow of resources.**	**There is a possible obligation or a present obligation where the likelihood of an outflow of resources is remote.**
A provision is recognised (paragraph 14).	No provision is recognised (para- graph 26).	No provision is recognised (para- graph 26).
Disclosures are required for the provision (paragraphs 66 and 67).	Disclosures are required for the contingent liability (paragraph 68).	No disclosure is required (paragraph 68).

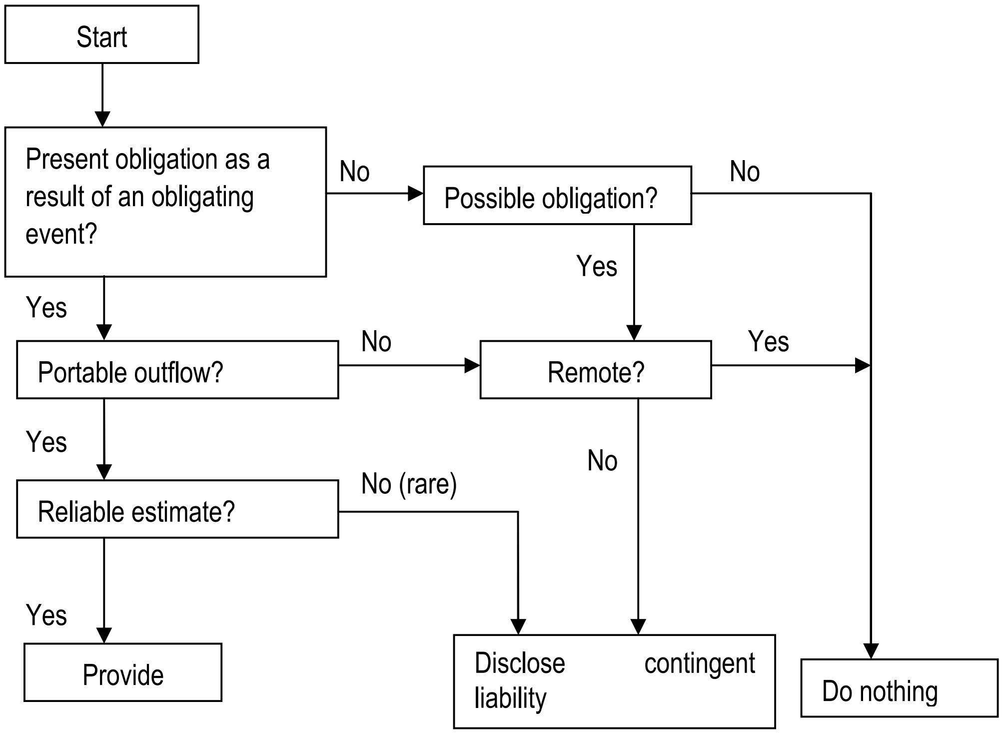
Reimbursements

Some or all of the expenditure required to settle a provision is expected to be reimbursed by another party.		
The enterprise has no obligation for the part of the expenditure to be reimbursed by the other party.	**The obligation for the amount expected to be reimbursed remains with the enterprise and it is virtually certain that reimbursement will be received if the enterprise settles the provision.**	**The obligation for the amount expected to be reimbursed remains with the enterprise and the reimbursement is not virtually certain if the enterprise settles the provision.**
The enterprise has no liability for the amount to be reimbursed (paragraph 50).	The reimbursement is recognised as a separate asset in the balance sheet and may be offset against the expense in the statement of profit and loss. The amount recognised for the expected reimbursement does not exceed the liability (paragraphs 46 and 47).	The expected reimbursement is not recognised as an asset (paragraph 46).
No disclosure is required.	The reimbursement is disclosed together with the amount recognised for the reimbursement (paragraph 67(c)).	The expected reimbursement is disclosed (paragraph 67(c)).

Illustration B

Decision Tree

The purpose of the decision tree is to summarise the main recognition requirements of the Accounting Standard for provisions and contingent liabilities. The decision tree does not form part of the Accounting Standard and should be read in the context of the full text of the Accounting Standard.



Note: in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date (paragraph 15 of the Standard).

Illustration C Illustrations: Recognition

This illustration illustrates the application of the Accounting Standard to assist in clarifying its meaning. It does not form part of the Accounting Standard.

All the enterprises in the Illustration have 31 March year ends. In all cases, it is assumed that a reliable estimate can be made of any outflows expected. In some Illustrations the circumstances described may have resulted in impairment of the assets - this aspect is not dealt with in the Illustrations.

The cross references provided in the Illustrations indicate paragraphs of the Accounting Standard that are particularly relevant. The illustration should be read in the context of the full text of the Accounting Standard.

Illustration 1: Warranties

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (i.e. more likely than not) that there will be some claims under the warranties.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product with a warranty, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement - Probable for the warranties as a whole (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the balance sheet date (see paragraphs 14 and 23).

Illustration 2: Contaminated Land - Legislation Virtually

Certain to be Enacted

An enterprise in the oil industry causes contamination but does not clean up because there is no legislation requiring cleaning up, and the enterprise has been contaminating land for several years. At 31 March 2005 it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end.

Present obligation as a result of a past obligating event - The obligating event is the contamination of the land because of the virtual certainty of legislation requiring cleaning up.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the costs of the clean-up (see paragraphs 14 and 21).

Illustration 3: Offshore Oilfield

An enterprise operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the seabed. Ninety per cent of the eventual costs relate to the removal of the oil rig and restoration of damage caused by building it, and ten per cent arise through the extraction of oil. At the balance sheet date, the rig has been constructed but no oil has been extracted.

Present obligation as a result of a past obligating event - The construction of the oil rig creates an obligation under the terms of the licence to remove the rig and restore the seabed and is thus an obligating event. At the balance sheet date, however, there is no obligation to rectify the damage that will be caused by extraction of the oil.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of ninety per cent of the eventual costs that relate to the removal of the oil rig and restoration of damage caused by building it (see paragraph 14). These costs are included as part of the cost of the oil rig. The ten per cent of costs that arise through the extraction of oil are recognised as a liability when the oil is extracted.

Illustration 4: Refunds Policy

A retail store has a policy of refunding purchases by dissatisfied customers, even though it is under no legal obligation to do so. Its policy of making refunds is generally known.

Present obligation as a result of a past obligating event - The obligating event is the sale of the product, which gives rise to an obligation because obligations also arise from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

An outflow of resources embodying economic benefits in settlement -

Probable, a proportion of goods are returned for refund (see paragraph 23).

Conclusion - A provision is recognised for the best estimate of the costs of refunds (see paragraphs 11, 14 and 23).

Illustration 5: Legal Requirement to Fit Smoke Filters

Under new legislation, an enterprise is required to fit smoke filters to its factories by 30 September 2005. The enterprise has not fitted the smoke filters.

(a) At the balance sheet date of 31 March 2005

Present obligation as a result of a past obligating event - There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation.

Conclusion - No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14 and 16-18).

(b) At the balance sheet date of 31 March 2006

Present obligation as a result of a past obligating event - There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

An outflow of resources embodying economic benefits in settlement - Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion - No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14 and 16-18).

Illustration 6: Staff Retraining as a Result of Changes in the Income Tax System

The government introduces a number of changes to the income tax system. As a result of these changes, an enterprise in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the balance sheet date, no retraining of staff has taken place.

Present obligation as a result of a past obligating event - There is no obligation because no obligating event (retraining) has taken place.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18).

Illustration 7: A Single Guarantee

During 2004-05, Enterprise A gives a guarantee of certain borrowings of Enterprise B, whose financial condition at that time is sound. During 2005-06, the financial condition of Enterprise B deteriorates and at 30 September 2005 Enterprise B goes into liquidation.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to an obligation.

An outflow of resources embodying economic benefits in settlement -

No outflow of benefits is probable at 31 March 2005.

Conclusion - No provision is recognised (see paragraphs 14 and 22). The guarantee is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (see paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - The obligating event is the giving of the guarantee, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement - At 31 March 2006, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

Conclusion - A provision is recognised for the best estimate of the obligation (see paragraphs 14 and 22).

Note: This example deals with a single guarantee. If an enterprise has a portfolio of similar guarantees, it will assess that portfolio as a whole in determining whether an outflow of resources embodying economic benefit is probable (see paragraph 23). Where an enterprise gives guarantees in exchange for a fee, revenue is recognised under AS 9, Revenue Recognition.

Illustration 8 : A Court Case

After a wedding in 2004-05, ten people died, possibly as a result of food poisoning from products sold by the enterprise. Legal proceedings are started seeking damages from the enterprise but it disputes liability. Up to the date of approval of the financial statements for the year 31 March 2005, the enterprise's lawyers advise that it is probable that the enterprise will not be found liable. However, when the enterprise prepares the financial statements for the year 31 March 2006, its lawyers advise that, owing to developments in the case, it is probable that the enterprise will be found liable.

(a) At 31 March 2005

Present obligation as a result of a past obligating event - On the basis of the evidence available when the financial statements were approved, there is no present obligation as a result of past events.

Conclusion - No provision is recognised (see definition of 'present obligation' and paragraph 15). The matter is disclosed as a contingent liability unless the probability of any outflow is regarded as remote (paragraph 68).

(b) At 31 March 2006

Present obligation as a result of a past obligating event - On the basis of the evidence available, there is a present obligation.

An outflow of resources embodying economic benefits in settlement - Probable.

Conclusion - A provision is recognised for the best estimate of the amount to settle the obligation (paragraphs 14-15).

Illustration 9A: Refurbishment Costs - No Legislative Requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the balance sheet date, the lining has been in use for three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The cost of replacing the lining is not recognised because, at the balance sheet date, no obligation to replace the lining exists independently of the company's future actions - even the intention to incur the expenditure depends on the company deciding to continue operating the furnace or to replace the lining.

Illustration 9B: Refurbishment Costs – Legislative Requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event - There is no present obligation.

Conclusion - No provision is recognised (see paragraphs 14 and 16-18). The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in illustration 9A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the enterprise's future actions - the enterprise could avoid the future expenditure by its future actions, for example by selling the aircraft.

Illustration 10: An Onerous Contract

An enterprise operates profitably from a factory that it has leased under an operating lease. During December 2005 the enterprise relocates its operations to a new factory. The lease on the old factory continues for the next four years, it connot be cancelled and the factory cannot be re-let to another user.

Present obligation as a result of a past obligating event-The obligating event occurs when the lease contract becomes binding on the enterprise, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement- When the lease becomes onerous, an outflow of resources embodying economic benefits is probable, (Until the lease becomes onerous, the enterprise accounts for the lease under AS 19, Leases).

Conclusion-A provision is recognised for the best estimate of the unavoidable lease payments.

Illustration D

Illustrations: Disclosure

This illustration does not form part of the Accounting Standard. Its purpose is to illustrate the application of the Accounting Standard to assist in clarifying its meaning.

An illustration of the disclosures required by paragraph 67 is provided below.

Illustration 1 Warranties

A manufacturer gives warranties at the time of sale to purchasers of its three product lines. Under the terms of the warranty, the manufacturer undertakes to repair or replace items that fail to perform satisfactorily for two years from the date of sale. At the balance sheet date, a provision of ₹ 60,000 has been recognised. The following information is disclosed:

A provision of ₹ 60,000 has been recognised for expected warranty claims on products sold during the last three financial years. It is expected that the majority of this expenditure will be incurred in the next financial year, and all will be incurred within two years of the balance sheet date.

An illustration is given below of the disclosures required by paragraph 72 where some of the information required is not given because it can be expected to prejudice seriously the position of the enterprise.

Illustration 2 Disclosure Exemption

An enterprise is involved in a dispute with a competitor, who is alleging that the enterprise has infringed patents and is seeking damages of ₹ 1000 lakh. The enterprise recognises a provision for its best estimate of the obligation, but discloses none of the information required by paragraphs 66 and 67 of the Standard. The following information is disclosed:

Litigation is in process against the company relating to a dispute with a competitor who alleges that the company has infringed patents and is seeking damages of ₹ 1000 lakh. The information usually required by AS 29, Provisions, Contingent Liabilities and Contingent Assets is not disclosed on the grounds that it can be expected to prejudice the interests of the company. The directors are of the opinion that the claim can be successfully resisted by the company.

INTERMEDIATE (IPC) COURSE

STUDY MATERIAL

PAPER : 5

ADVANCED ACCOUNTING

MODULE – 2

BOARD OF STUDIES

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Study Material has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge in the subject. In case students need any clarifications or have any suggestions to make for further improvement of the material contained herein, they may write to the Director of Studies.

All care has been taken to provide interpretations and discussions in a manner useful for the students. However, the study material has not been specifically discussed by the Council of the Institute or any of its Committees and the views expressed herein may not be taken to necessarily represent the views of the Council or any of its Committees.

Revised Edition	:	July, 2015
Website	:	www.icai.org
E-mail	:	bos@icai.in
Committee/ Department	:	Board of Studies
ISBN No.	:	
Price(All Modules)	:	
Published by	:	The Publication Department on behalf of The Institute of Chartered Accountants of India, ICAI Bhawan, Post Box No. 7100, Indraprastha Marg, New Delhi 110 002, India.
Printed by	:	

CONTENTS

DETAILED CONTENTS : MODULE – 2

4
Company Accounts

Unit – 1: ESOP and Buy-back of Shares

Learning Objectives

After studying this unit, you will be able to

- Learn the provisions of the Companies Act 2013 regarding employees' stock option.
- Understand the accounting policies of employees' stock option plan.
- Learn the accounting treatment of employees' stock options.
- Learn the provisions of Guidance Note on Employee Share-Based Payments.
- Learn the provisions of the Companies Act regarding buyback of securities
- Understand equity shares with differential rights.

1.1 Employees Stock Option Plan

Under Section 62 (1) (b) of the Companies Act 2013, where at any time a company having a share capital proposes to increase its subscribed capital by the issue of further shares, such shares may be offered to employees under a scheme of employees' stock option, subject to a special resolution passed by the company and subject to such conditions as may be prescribed.

Earlier Securities and Exchange Board of India (SEBI) issued Employees Stock Option Scheme and Employee Stock Purchase Scheme Guidelines (applicable for listed companies) in 1999 under section 11 of the Securities and Exchange Board of India Act, 1992. This guideline has now been replaced by the SEBI (Share Based Employee Benefits) Regulations, 2014* (applicable for listed companies). It cover the provisions regarding accounting policies, pricing, disclosures, administration and implementation process of various schemes and other issues relating to Employee Stock Option

---

* ***SEBI (Share Based Employee Benefits) Regulations, 2014 has been issued on October 28, 2014 and are applicable from the same date.***

Scheme (ESOS), Employee Stock Purchase Scheme (ESPS), Stock Appreciation Rights Scheme (SRS), General Employee Benefits Scheme (GEBS) and Retirement Benefit Scheme (RBS). The Regulation stipulate to follow the requirements of the 'Guidance Note on Accounting for Employee Share Based Payments' or Accounting Standards as may be prescribed by the ICAI from time to time including the disclosure requirements prescribed therein.

1.1.1 Important terms to be remembered

1. ***Grant***: Grant means issue of option to the employees under ESOS.
2. ***Vesting:*** It is the process by which the employee is given the right to apply for shares of the company against the option granted to him in purchase of employee in pursuance of employee stock option scheme (ESOS).
3. ***Vesting Period****:* It is the time period during which the vesting of the option granted to the employee on pursuance of ESOS takes place.
4. ***Option****:* Option means a right but not an obligation granted to an employee in pursuance of ESOS to apply for shares of the company at a pre-determined price.
5. ***Exercise Period:*** It is the time period after vesting within which the employee should exercise his right to apply for shares against the option vested in him in pursuance of the ESOS.
6. ***Exercise Price:*** It is the price payable by the employee for exercising the option granted to him in pursuance of ESOS.
7. ***Intrinsic Value:*** It is the excess of the market price of the share under ESOS over the exercise price of the option (including up-front payment, if any).
8. ***Fair Value:*** It is the amount for which stock option granted or a share offered for purchase could be exchanged between knowledgeable, willing parties in an arm's length transaction.

1.1.2 Provisions of Guidance Note on Employee Share-Based Payments

Recognizing the need for establishing uniform sound accounting principles and practices for all types of share-based payments, the Accounting Standards Board of the Institute is developing an Accounting Standard covering various types of share-based payments including employee share-based payments. However, as the formulation of the Standard is likely to take some time, the Institute has decided to bring out this Guidance Note. Once the Accounting Standard dealing with Share-based Payments comes into force, this Guidance Note will automatically stand withdrawn.

This Guidance Note establishes financial accounting and reporting principles for employee share-based payment plans, viz., employee stock option plans, employee stock purchase plans and stock appreciation rights. For the purposes of this Guidance Note, the term 'employee' includes a director of the enterprise, whether whole time or not.

For accounting purposes, employee share-based payment plans are classified into the following categories:

- Equity-settled: Under these plans, the employees receive shares.
- Cash-settled: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares.
- Employee share-based payment plans with cash alternatives: Under these plans, either the enterprise or the employee has a choice of whether the enterprise settles the payment in cash or by issue of shares.

An enterprise should recognize as an expense (except where service received qualifies to be included as a part of the cost of an asset) the services received in an equity-settled employee share-based payment plan when it receives the services, with a corresponding credit to an appropriate equity account, say, 'Stock Options Outstanding Account'. This account is transitional in nature as it gets ultimately transferred to another equity account such as share capital, securities premium account and/or general reserve as recommended in this Guidance Note. If the shares or stock options granted vest immediately, the employee is not required to complete a specified period of service before becoming unconditionally entitled to those instruments. In the absence of evidence to the contrary, the enterprise should presume that services rendered by the employee as consideration for the instruments have been received. In this case, on the grant date, the enterprise should recognize services received in full with a corresponding credit to the equity account. If the shares or stock options granted do not vest until the employee completes a specified period of service, the enterprise should presume that the services to be rendered by the employee as consideration for those instruments will be received in the future, during the vesting period. The enterprise should account for those services as they are rendered by the employee during the vesting period, on a time proportion basis, with a corresponding credit to the equity account.

An enterprise should measure the fair value of shares or stock options granted at the grant date, based on market prices if available, taking into account the terms and conditions upon which those shares or stock options were granted. If market prices are not available, the enterprise should estimate the fair value of the instruments granted using a valuation technique to estimate what the price of those instruments would have been on the grant date in an arm's length transaction between knowledgeable, willing parties. The valuation technique should be consistent with generally accepted valuation methodologies for pricing financial instruments (e.g., use of an option pricing model for valuing stock options) and should incorporate all factors and assumptions that knowledgeable, willing market participants would consider in setting the price. Vesting conditions, other than market conditions, should not be taken into account when estimating the fair value of the shares or stock options at the grant date. Instead, vesting conditions should be taken into account by adjusting the number of shares or stock options included in the measurement of the transaction amount so that, ultimately, the amount recognized for employee services received as consideration for the shares or stock options granted is based on the number of shares or stock options that eventually vest. Hence, on a cumulative basis, no amount is recognized for employee services received if the shares or stock options granted do not vest because of failure to satisfy a vesting condition (i.e., these are forfeited), e.g., the employee fails to complete a specified service period, or a performance condition is not satisfied.

To apply the requirements of the Guidance Note, the enterprise should recognize an amount for the employee services received during the vesting period based on the best available estimate of the number of shares or stock options expected to vest and should revise that estimate, if necessary, if subsequent information indicates that the number of shares or stock options expected to vest differs from previous estimates. On vesting date, the enterprise should revise the estimate to equal the number of shares or stock options that ultimately vest. Market conditions, such as a target share price upon which vesting (or right to exercise) is conditioned, should be taken into account when estimating the fair value of the shares or stock options granted. On exercise of the right to obtain shares or stock options, the enterprise issues shares on receipt of the exercise price. The shares so issued should be considered to have been issued at the consideration comprising the exercise price and the corresponding amount standing to the credit of the relevant equity account (e.g., Stock Options Outstanding Account). In a situation where the right to obtain shares or stock option expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to general reserve.

For cash-settled employee share-based payment plans, the enterprise should measure the services received and the liability incurred at the fair value of the liability. Until the liability is settled, the enterprise is required to re-measure the fair value of the liability at each reporting date and at the date of settlement, with any changes in value recognized in profit or loss for the period.

For employee share-based payment plans in which the terms of the arrangement provide either the enterprise or the employee with a choice of whether the enterprise settles the transaction in cash or by issuing shares, the enterprise is required to account for that transaction, or the components of that transaction, as a cash-settled share-based payment plan if, and to the extent that, the enterprise has incurred a liability to settle in cash (or other assets), or as an equity-settled share-based payment plan if, and to the extent that, no such liability has been incurred.

Accounting for employee share-based payment plans is based on the fair value method. There is another method known as the 'Intrinsic Value Method' for valuation of employee share-based payment plans. Intrinsic value, in the case of a listed company, is the amount by which the quoted market price of the underlying share exceeds the exercise price of an option. In the case of a non-listed company, since the shares are not quoted on a stock exchange, value of its shares is determined on the basis of a valuation report from an independent valuer. For accounting for employee share-based payment plans, the intrinsic value may be used, mutatis mutandis, in place of the fair value as described in paragraphs 5 to 14.

Apart from the above, the Guidance Note also deals with various other significant aspects of the employee share-based payment plans including those related to performance conditions, modifications to the terms and conditions of the grant of shares or stock options, reload feature, graded vesting, earnings-per-share implications, accounting for employee share-based payments administered through a trust, etc. The Guidance Note also recommends detailed disclosure requirements.

Illustration 1

A Company has its share capital divided into shares of ₹ 10 each. On 1st April, 2012 it granted 10,000 employees' stock options at ₹ 40, when the market price was ₹ 130. The options were to be exercised between 15th March, 2013 and 31st March, 2013. The employees exercised their options for 9,500 shares only; the remaining options lapsed. The company closes its books on 31st March every year.

Show Journal Entries.

Solution

Journal Entries

	Particulars	*Dr.* ₹	*Cr.* ₹
15th Mar. 2013 to 31st Mar.2013	Bank A/c Dr. Employee compensation expense A/c Dr. To Equity share capital A/c To Securities premium A/c (Being allotment to employees of 9,500 equity shares of ₹ 10 each at a premium of ₹ 120 per share in exercise of stock options by employees)	3,80,000 8,55,000	 95,000 11,40,000
31st March 2013	Profit and Loss A/c Dr. To Employee compensation expense A/c (Being transfer of employee compensation expense to profit and loss account)	8,55,000	 8,55,000

Illustration 2

ABC Ltd. grants 1,000 employees stock options on 1.4.2010 at ₹ 40, when the market price is ₹ 160. The vesting period is 2½ years and the maximum exercise period is one year. 300 unvested options lapse on 1.5.2012. 600 options are exercised on 30.6.2013. 100 vested options lapse at the end of the exercise period.

Pass Journal Entries giving suitable narrations.

Solution

In the books of ABC Ltd.

Journal Entries

Date	*Particulars*		*Dr. (₹)*	*Cr. (₹)*
31.3.2011	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of ₹ 120 each, amortised on straight line basis over 2 $\frac{1}{2}$ years - 1,000 stock options x ₹ 120/2.5 years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.2012	Employees compensation expenses account	Dr.	48,000	
	To Employee stock option outstanding account			48,000
	(Being compensation expense recognized in respect of the employee stock option i.e. 1,000 options granted to employees at a discount of ₹ 120 each, amortised on straight line basis over 2 $\frac{1}{2}$ years - 1,000 stock options x ₹ 120/2.5 years)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at year end)			
31.3.2013	Employee stock option outstanding account (W.N.1)	Dr.	12,000	
	To General Reserve account (W.N.1)			12,000
	(Being excess of employees compensation expenses transferred to general reserve account)			
30.6.2013	Bank A/c (600 × ₹ 40)	Dr.	24,000	
	Employee stock option outstanding account (600 × ₹ 120)	Dr.	72,000	

	To Equity share capital account (600 × ₹ 10)			6,000
	To Securities premium account (600 x ₹ 150)			90,000
	(Being 600 employee stock option exercised at an exercise price of ₹ 40 each)			
01.10.2013	Employee stock option outstanding account (W.N.2)	Dr.	12,000	
	To General reserve account (W.N.2)			12,000
	(Being ESOS outstanding A/c on lapse of 100 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Notes:

1. At 31.3.2013, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that actually vested. Considering that 700 stock options have completed 2.5 years vesting period, the expense to be recognized during the year is in negative i.e.

No. of options actually vested (700 x 120)	₹ 84,000
Less: Expenses recognized ₹ (48,000 + 48,000)	(₹ 96,000)
Excess expenses transferred to general reserve	₹ 12,000

2. Similarly, on 1.10.2013, Employee Stock Option Outstanding Account will be

No. of options actually vested (600 x 120)	₹ 72,000
Less: Expenses recognized	(₹ 84,000)
Excess expenses transferred to general reserve	₹ 12,000

Employee Stock Options Outstanding will appear in the Balance Sheet as part of Net Worth or Shareholders' Fund.

Illustration 3

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2009 for ₹ 20, depending upon the employees at the time of vesting of options. Options would be exercisable within a year it is vested. The market price of the share is ₹ 50 each. These options will vest at the end of year 1 if the earning of Choice Ltd. is 16%, or it will vest at the end of the year 2 if the average earning of two years is 13%, or lastly it will vest at the end of the third year if the average earning of 3 years will be 10%. 5,000 unvested options lapsed on 31.3.2010. 4,000 unvested options lapsed on 31.3.2011 and finally 3,500 unvested options lapsed on 31.3.2012.

Following is the earning of Choice Ltd. :

Year ended on	*Earning (in %)*
31.3.2010	*14%*

31.3.2011	*10%*
31.3.2012	*7%*

850 employees exercised their vested options within a year and remaining options were unexercised at the end of the contractual life. Pass Journal entries for the above.

Solution

Date	*Particulars*		₹	₹
31.3.2010	Employees compensation expenses A/c	Dr.	14,25,000	
	To ESOS outstanding A/c			14,25,000
	(Being compensation expense recognized in respect of the ESOP i.e. 100 options each granted to 1,000 employees at a discount of ₹ 30 each, amortised on straight line basis over vesting years- Refer W.N.)			
	Profit and Loss A/c	Dr.	14,25,000	
	To Employees compensation expenses A/c			14,25,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.2011	Employees compensation expenses A/c	Dr.	3,95,000	
	To ESOS outstanding A/c			3,95,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c	Dr.	3,95,000	
	To Employees compensation expenses A/c			3,95,000
	(Being expenses transferred to profit and Loss A/c)			
31.3.2012	Employees compensation Expenses A/c	Dr.	8,05,000	
	To ESOS outstanding A/c			8,05,000
	(Being compensation expense recognized in respect of the ESOP- Refer W.N.)			
	Profit and Loss A/c		8,05,000	
	To Employees compensation expenses A/c			8,05,000
	(Being expenses transferred to profit and Loss A/c)			
2012-13	Bank A/c (85,000 × ₹ 20)	Dr.	17,00,000	
	ESOS outstanding A/c	Dr.	25,50,000	

	[(26,25,000/87,500) x 85,000]			
	To Equity share capital (85,000 x ₹ 10)			8,50,000
	To Securities premium A/c (85,000 x ₹ 40)			34,00,000
	(Being 85,000 options exercised at an exercise price of ₹ 50 each)			
31.3.2013	ESOS outstanding A/c	Dr.	75,000	
	To General Reserve A/c			75,000
	(Being ESOS outstanding A/c on lapse of 2,500 options at the end of exercise of option period transferred to General Reserve A/c)			

Working Note:

Statement showing compensation expenses to be recognized at the end of

Particulars	Year 1 (31.3.2010)	Year 2 (31.3.2011)	Year 3 (31.3.2012)
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expense accrued (50-20)	₹ 28,50,000	₹ 27,30,000	₹ 26,25,000
Compensation expense of the year	28,50,000 x 1/2 = ₹ 14,25,000	27,30,000 x 2/3 = ₹ 18,20,000	₹ 26,25,000
Compensation expense recognized previously	Nil	₹ 14,25,000	₹ 18,20,000
Compensation expenses to be recognized for the year	₹ 14,25,000	₹ 3,95,000	₹ 8,05,000

1.2 Buy Back of Securities

The Companies Act, 2013 under Section 68 (1) permits companies to buyback their own shares and other specified securities out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of the issue of any shares or other specified securities.

Note: No buy-back of any kind of shares or other specified securities shall be made out of the proceeds of an earlier issue of the same kind of shares or same kind of other specified securities.

The other important provisions relating to the buyback are:

(1) Section 68 (2) further states that no company shall purchase its own shares or other specified securities unless—

   (a) the buy-back is authorised by its articles;

   (b) a special resolution has been passed in general meeting of the company authorising the buy-back;

   However, the above provisions do not apply where the buy back is ten percent or less of the paid up equity capital + free reserves and is authorized by a board resolution passed at a duly convened meeting of the directors. Hence, in case the buy back is upto 10% of paid up equity + free reserves, the same may be done with the authorization of the Board Resolution without the necessity of its being authorized by the articles of association of the company and by a special resolution of its members passed at a general meeting of the company.

   (c) the buy-back is equal or less than twenty-five per cent of the total paid-up capital and free reserves of the company:

   (d) the ratio of the debt owed by the company (both secured and unsecured) after such buy - back is not more than twice the total of its paid up capital and its free reserves:

   Note: Central Government may prescribe a higher ratio of the debt than that specified under this clause for a class or classes of companies.

   (e) all the shares or other specified securities for buy-back are fully paid-up;

   (f) the buy-back of the shares or other specified securities listed on any recognised stock exchange is in accordance with the regulations made by the Securities and Exchange Board of India in this behalf;

   (g) the buy-back in respect of shares or other specified securities other than those specified in clause (f) is in accordance with the guidelines as may be prescribed.

   Provided that no offer of buy back under this sub section shall be made within a period of one year reckoned from the date of closure of a previous offer of buy back if any. This means that there cannot be more than one buy back in one year.

(2) Every buy-back shall be completed within twelve months from the date of passing the special resolution, or the resolution passed by the board of directors where the buy back is upto 10% of the paid up equity capital + free reserves.

(3) The buy-back may be—

(a) from the existing security holders on a proportionate basis; or

(b) from the open market; or

(c) by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or sweat equity.

(4) Where a company has passed a special resolution under clause (b) of Sub-section (2) to buy-back its own shares or other securities under this section, it shall, before making such buy-back, file with the Registrar and the Securities and Exchange Board of India a declaration of solvency in the form as may be prescribed and verified by an affidavit to the effect that the Board has made a full inquiry into the affairs of the company as a result of which they have formed an opinion that it is capable of meeting its liabilities and will not be rendered insolvent within a period of one year of the date of declaration adopted by the Board, and signed by at least two directors of the company, one of whom shall be the managing director, if any :

Note: No declaration of solvency shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

(5) Where a company buys-back its own securities, it shall extinguish and physically destroy the securities so bought-back within seven days of the last date of completion of buy-back.

(6) Where a company completes a buy-back of its shares or other specified securities under this section, it shall not make further issue of same kind of shares (including allotment of further shares under clause (a) of Sub-section (1) of Section (62) or other specified securities within a period of six months except by way of bonus issue or in the discharge of subsisting obligations such as conversion of warrants, stock option scheme, sweat equity or conversion of preference shares or debentures into equity shares.

(7) If a company makes default in complying with the provisions of this section or any regulations made by SEBI in this regard, the company may be punishable with a fine which shall not be less than Rs One Lakh but which may extend to three lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for upto 3 years or with a fine of not less than one lakh rupees but which may extend to three lakh rupees or with both.

(8) Section 69 (1) states that where a company purchases its own shares out of the free reserves or securities premium account, a sum equal to the nominal value of shares so purchased shall be transferred to the Capital Redemption Reserve Account and details of such account shall be disclosed in the Balance Sheet.

(9) The Capital Redemption Reserve Account may be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully paid bonus shares.

(10) Where a company buy-back its securities under this section, it shall maintain a register of the securities so bought, the consideration paid for the securities bought-back, the date of cancellation of securities, the date of extinguishing and physically destroying of securities and such other particulars as may be prescribed.

(11) A company shall, after the completion of the buy-back under this section, file with the Registrar and the Securities and Exchange Board of India, a return containing such particulars relating to the buy-back within thirty days of such completion, as may be prescribed, provided that no return shall be filed with the Securities and Exchange Board of India by a company whose shares are not listed on any recognised stock exchange.

Some Important Terms

(a) "specified securities" includes employees' stock option or other securities as may be notified by the Central Government from time to time;

(b) "free reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as dividend:

Provided that-

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as a reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value, shall not be treated as free reserves;

1.2.1 Provisions of Section 70 of the Companies Act 2013

(1) No company shall directly or indirectly purchase its own shares or other specified securities—

(a) through any subsidiary company including its own subsidiary companies; or

(b) through any investment company or group of investment companies; or

(c) if a default, by the company, in repayment of deposit or interest payable thereon, redemption of debentures or preference shares or payment of dividend to any shareholder or repayment of any term loan or interest payable thereon to any financial institutions or bank, is subsisting. Provided that the buy – back is not prohibited if the default is remedied and a period of three years has elapsed since the cessation of the default.

(2) No company shall directly or indirectly purchase its own shares or other specified securities in case such company has not complied with provisions of Sections 92,123, 127 and 129. Section 92 relates to the filing of Annual Return, Section 123 and 127 to declaration and payment of dividend and Section 129 to the financial statement of the company.

<u>NOTE</u>: In exercise of the powers conferred under section 30 of the Securities and Exchange Board of India Act, 1992, SEBI made Securities and Exchange Board of India (Buy-back of

Securities) (Amendment) Regulations, 2013 to amend the Securities and Exchange Board of India (Buy back of Securities) Regulations, 1998. The important provisions of the new regulations are: (i) No offer of buy-back for fifteen per cent or more of the paid up capital and free reserves of the company shall be made from the open market. (ii)A company shall not make any offer of buy-back within a period of one year reckoned from the date of closure of the preceding offer of buy-back, if any. (iii)The company shall ensure that at least fifty per cent of the amount earmarked for buy-back is utilized for buying-back shares or other specified securities.

Illustration 4

Perrotte Ltd. (a non-listed company) has the following Capital Structure as on 31.03.2011:

	Particulars	*(₹ in crores)*	
(1)	*Equity Share Capital (Shares of ₹ 10 each fully paid)*	*-*	*330*
(2)	*Reserves and Surplus*		
	General Reserve	*240*	*-*
	Securities Premium Account	*90*	*-*
	Profit & Loss Account	*90*	*-*
	Infrastructure Development Reserve	*180*	*600*
(3)	*Loan Funds*		*1,800*

The Shareholders of Perrotte Ltd., on the recommendation of their Board of Directors, have approved on 12.09.2011 a proposal to buy back the maximum permissible number of Equity shares considering the large surplus funds available at the disposal of the company.

The prevailing market value of the company's shares is ₹ 25 per share and in order to induce the existing shareholders to offer their shares for buy back, it was decided to offer a price of 20% over market.

You are also informed that the Infrastructure Development Reserve is created to satisfy Income-tax Act requirements.

You are required to compute the maximum number of shares that can be bought back in the light of the above information and also under a situation where the loan funds of the company were either ₹ 1,200 crores or ₹ 1,500 crores.

Assuming that the entire buy back is completed by 09.12.2011, show the accounting entries in the company's books in each situation.

Solution

Statement determining the maximum number of shares to be bought back

Number of shares

Particulars	*When loan fund is*		
	₹ 1,800 crores	*₹ 1,200 crores*	*₹ 1,500 crores*
Shares Outstanding Test (W.N.1)	8.25	8.25	8.25
Resources Test (W.N.2)	6.25	6.25	6.25
Debt Equity Ratio Test (W.N.3)	Nil	3.75	Nil
Maximum number of shares that can be bought back [least of the above]	Nil	3.75	Nil

Journal Entries for the Buy Back (applicable only when loan fund is ₹ 1,200 crores)

			₹ in crores	
			Debit	*Credit*
(a)	Equity share buy back account	Dr.	112.5	
	To Bank account			112.5
	(Being buy back of 3.75 crores equity shares of ₹ 10 each @ ₹ 30 per share)			
(b)	Equity share capital account	Dr.	37.5	
	Securities premium account	Dr.	75	
	To Equity share buy back account			112.5
	(Being cancellation of shares bought back)			
(c)	General reserve account	Dr.	37.5	
	To Capital redemption reserve account			37.5
	(Being transfer of free reserves to capital redemption reserve to the extent of nominal value of share capital bought back out of redeemed through free reserves)			

Working Notes:

1. **Shares Outstanding Test**

Particulars	*(Shares in crores)*
Number of shares outstanding	33
25% of the shares outstanding	8.25

2. **Resources Test**

Particulars	
Paid up capital (₹ in crores)	330

Free reserves (₹ in crores)	420
Shareholders' funds (₹ in crores)	750
25% of Shareholders fund (₹ in crores)	₹ 187.5 crores
Buy back price per share	₹ 30
Number of shares that can be bought back (shares in crores)	6.25 crores shares

3. Debt Equity Ratio Test

	Particulars	*When loan fund is*		
		₹ 1,800 crores	*₹ 1,200 crores*	*₹ 1,500 crores*
(a)	Loan funds (₹ in crores)	1,800	1,200	1,500
(b)	Minimum equity to be maintained **after** buy back in the ratio of 2:1 (₹ in crores)	900	600	750
(c)	Present equity shareholders fund (₹ in crores)	750	750	750
(d)	Future equity shareholder fund (₹ in crores) **(See Note 2)**	N.A.	712.5 (750-37.5)	N.A.
(e)	Maximum permitted buy back of Equity (₹ in crores) [(d) – (b)] **(See Note 2)**	Nil	112.5 (by simultaneous equation)	Nil
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) **(See Note 2)**	Nil	3.75 (by simultaneous equation)	Nil

Note:

1. Under Situations 1 & 3 the company does not qualify for buy back of shares as per the provisions of the Companies Act, 2013.

2. As per section 68 of the Companies Act, 2013, the ratio of debt owed by the company should not be more than twice the capital and its free reserve after such buy-back. In the question, it is stated that the company has surplus funds to dispose off therefore, it is presumed that buy- back is out of free reserves or securities premium and hence a sum equal to the nominal value of the share bought back shall be transferred to Capital Redemption Reserve (CRR). Utilization of CRR is restricted to issuance of fully paid-up bonus shares only. It means CRR is not available for distribution as dividend. Hence, CRR is not a free reserve. Therefore, for calculation of future equity i.e. share capital and free reserves, amount transferred to CRR on buyback has to be excluded from present equity.

   Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

Suppose amount equivalent to nominal value of bought back shares transferred to CRR account is ‘x’ and maximum permitted buy-back of equity is ‘y’.

Then

Equation 1 :(Present equity – Nominal value of buy-back transfer to CRR) – Minimum equity to be maintained= Maximum permissible buy-back of equity

$$(750 - x) - 600 = y \qquad (1)$$

Since $150 - x = y$

Equation 2: $\left(\frac{\text{Maximum buy - back}}{\text{Offer price for buy - back}} \text{x Nominal Value} \right)$

= Nominal value of the shares bought –back to be transferred to CRR

$$= \left(\frac{y}{30} \times 10 \right) = x$$

[here (30 = 25% x 120]

Or $3x = y \qquad (2)$

by solving the above two equations we get

x = ₹ 37.5 crores

y = ₹ 112.5 crores

Illustration 5

Anu Ltd. (a non-listed company) furnishes you with the following summarized balance sheet as at 31st March, 2012:

		(₹ in crores)
Sources of Funds		
Share Capital:		
Authorised		*100*
Issued:		
12% Redeemable preference shares of ₹ 100 each fully paid	*75*	
Equity shares of ₹ 10 each fully paid	*25*	*100*
Reserves and surplus:		
Capital reserve	*15*	
Securities premium	*25*	
Revenue reserves	*260*	*300*
		400

Application of Funds		
Fixed assets: cost	*100*	
Less: Provision for depreciation	*(100)*	*Nil*
Non-current investments at cost (Market value ₹ 400 Cr.)		*100*
Current assets	*340*	
Less: Current liabilities (Trade payables)	*(40)*	*300*
		400

The company redeemed preference shares on 1st April, 2012. It also bought back 50 lakhs equity shares of ₹ 10 each at ₹ 50 per share. The payments for the above were made out of the huge bank balances, which appeared as a part of current assets.

You are asked to:

(i) Pass journal entries to record the above.

(ii) Prepare balance sheet as at 1.4.2012.

Solution

Journal entries in the books of Anu Ltd.

₹ in crores

	Particulars		*Debit*	*Credit*
1st April, 2012	12% Preference share capital A/c	Dr.	75	
	To Preference shareholders A/c			75
	(Being preference share capital account transferred to shareholders account)			
	Preference shareholders A/c	Dr.	75	
	To Bank A/c			75
	(Being payment made to shareholders)			
	Shares buy back A/c	Dr.	25	
	To Bank A/c			25
	(Being 50 lakhs equity shares bought back @ ₹ 50 per share)			
	Equity share capital A/c (50 lakhs x ₹ 10)	Dr.	5	
	Securities premium A/c (50 lakhs x ₹ 40)	Dr.	20	
	To Shares buy back A/c			25
	(Being cancellation of shares bought back)			
	Revenue reserve A/c	Dr.	80	
	To Capital Redemption Reserve A/c (75+5)			80
	(Being creation of capital redemption reserve to the extent of the face value of preference shares redeemed and equity shares bought back)			

(ii) Balance Sheet of Anu Ltd as at 1.4.2012

Particulars	*Note No*	*₹ in crores*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20
(b) Reserves and Surplus	2	280
(2) Current Liabilities		
(a) Trade payables		40
Total		340
II. Assets		
(1) Non-current assets		
(a) Fixed assets	3	-
(b) Non-current investments -Investment at cost (Market value ₹ 400 crores)		100
(2) Current assets	4	240
Total		340

Notes to Accounts

1.	**Share Capital**			*₹ in crores*
	Authorised, Issued and Subscribed			
	200 lakhs Equity shares of ₹ 10 each			20
2.	**Reserves and Surplus**			
	Capital reserve		15	
	Capital redemption reserve		80	
	Securities premium	25		
	Less: Utilisation for buy back of shares	(20)	5	
	Revenue Reserve	260		
	Less: transfer to Capital redemption reserve	(80)	180	280
3.	**Fixed Assets**			
	Cost		100	
	Less : Provision for depreciation		(100)	-
4.	**Current assets**			
	Current assets as on 31.3.2012		340	
	Less: Bank payment for redemption and buy back		(100)	240

Illustration 6

Extra Ltd. (a non-listed company) furnishes you with the following summarized Balance Sheet as on 31st March, 2012:

(₹ in lakhs)

Liabilities	*Amount*	*Assets*	*Amount*
Equity shares of ₹ 10 each fully paid	*100*	*Fixed assets less depreciation*	*50*
9% Redeemable preference		*Investments at cost*	*120*
shares of ₹ 100 each fully paid	*20*	*Current assets*	*142*
Capital reserves	*8*		
Revenue reserves	*50*		
Securities premium	*60*		
10% Debentures	*4*		
Current liabilities	*70*		
	312		*312*

(i) The company redeemed the preference shares at a premium of 10% on 1st April, 2012.

(ii) It also bought back 3 lakhs equity shares of ₹ 10 each at ₹ 30 per share.

The payment for the above was made out of huge bank balances, which appeared as a part of the current assets.

(iii) Included in its investment were "investments in own debentures" costing ₹ 2 lakhs (face value ₹ 2.20 lakhs). These debentures were cancelled on 1st April, 2012.

(iv) The company had 1,00,000 equity stock options outstanding on the above mentioned date, to the employees at ₹ 20 when the market price was ₹30 (This was included under current liabilities). On 1.04.2012 employees exercised their options for 50,000 shares.

(v) Pass the journal entries to record the above.

(vi) Prepare Balance Sheet as at 01.04.2012.

Solution

(₹ in lakhs)

Date	*Particulars*		*Debit*	*Credit*
01.04.2012	9% Redeemable preference share capital A/c	Dr.	20.00	
	Premium on redemption of preference shares A/c	Dr.	2.00	
	To Preference shareholders A/c			22.00
	(Being preference share capital transferred to shareholders account)			

01.04.2012	Preference shareholders A/c	Dr.	22.00	
	To Bank A/c			22.00
	(Being payment made to shareholders)			
01.04.2012	Equity shares buy back A/c	Dr.	90.00	
	To Bank A/c			90.00
	(Being 3 lakhs equity shares of ₹ 10 each bought back @ ₹30 per share)			
01.04.2012	Equity share capital A/c	Dr.	30.00	
	Securities premium A/c	Dr.	60.00	
	To Equity Shares buy back A/c			90.00
	(Being cancellation of shares bought back)			
01.04.2012	Revenue reserve A/c	Dr.	50.00	
	To Capital redemption reserve A/c			50.00
	(Being creation of capital redemption reserve account to the extent of the face value of preference shares redeemed and equity shares bought back as per the law)			
01.04.2012	10% Debentures A/c	Dr.	2.20	
	To Investment (own debentures) A/c			2.00
	To Profit on cancellation of own debentures A/c			0.20
	(Being cancellation of own debentures costing ₹ 2 lakhs, face value being ₹ 2.20 lakhs and the balance being profit on cancellation of debentures)			
1.04.2012	Profit on cancellation of debentures A/c	Dr.	0.20	
	To Capital reserve A/c			0.20
	(Being profit on cancellation of debentures transferred to capital reserve account)			
01.04.2012	Bank A/c	Dr.	10.00	
	Employees stock option outstanding (Current liabilities) A/c	Dr.	5.00	
	To Equity share capital A/c			5.00
	To Securities premium A/c			10.00
	(Being the allotment to employees, of 50,000 shares of ₹ 10 each at a premium of 20 per share in exercise of stock options by employees)			

01.04.2012	Securities premium A/c To Premium on redemption of preference (Being premium on redemption of preference shares adjusted through securities premium)	Dr.	2.00	2.00

Balance Sheet of Extra Ltd. as on 01.04.2012

Particulars	*Note No*	*(₹ in lakhs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	75.00
(b) Reserves and Surplus	2	66.20
(2) Non-current Liabilities		
(a) Long term borrowings	3	1.80
(3) Current Liabilities		65.00
Total		208.00
II. Assets		
(1) Non-current assets		
(a) Fixed assets		50.00
(b) Non-current investments at cost		118.00
(2) Current assets		40.00
Total		208.00

Notes to Accounts

			₹ in lakhs
1	**Share Capital**		
	Equity share capital		
	Opening balance	100.00	
	Less : Cancellation of bought back shares	(30.00)	
	Add : Shares issued against ESOP	5.00	75.00
2	**Reserves and Surplus**		
	Capital Reserve		
	Opening balance	8.00	
	Add: Profit on cancellation of debentures	0.20	8.20

	Revenue reserves		
	Opening balance	50.00	
	Less: Creation of Capital Redemption Reserve	(50.00)	-
	Securities Premium		
	Opening balance	60.00	
	Less : Adjustment for cancellation of equity shares	(60.00)	
	Less: Adjustment for premium on redemption of preference shares	(2.00)	
	Add: Shares issued against ESOP at premium	10.00	8.00
	Capital Redemption Reserve		50.00
			66.20
3	**Long term borrowings**		
	Secured		
	10% Debentures (4-2.20)		1.80

Working Notes:

		(₹ in lakhs)
1.	**10% Debentures**	
	Opening balance	4.00
	Less: Cancellation of own debentures	(2.20)
		1.80
2.	**Current liabilities**	
	Opening balance	70.00
	Less: Adjustment for ESOP outstanding	(5.00)
		65.00
3.	**Investments at cost**	
	Opening balance	120.00
	Less: Investment in own debentures	(2.00)
		118.00
4.	**Current assets**	
	Opening balance	142.00
	Less : Payment to preference shareholders	(22.00)
	Less : Payment to equity shareholders	(90.00)
	Add : Share price received against ESOP	10.00
		40.00

Illustration 7

Dee Limited (a non-listed company) furnishes the following summarized Balance Sheet as at 31st March, 2012:

	₹ '000	₹ '000
Liabilities		
Share capital:		
Authorised capital		*30,00*
Issued and subscribed capital:		
2,50,000 Equity shares of ₹ 10 each fully paid up	*25,00*	
2,000, 10% Preference shares of ₹ 100 each	*2,00*	
(Issued two months back for the purpose of buy back)		*27,00*
Reserves and surplus:		
Capital reserve	*10,00*	
Revenue reserve	*30,00*	
Securities premium	*22,00*	
Profit and loss account	*35,00*	*97,00*
Current liabilities and provisions		*14,00*
		1,38,00
Assets		
Fixed assets		*93,00*
Investments		*30,00*
Current assets, loans and advances (including cash and bank balance)		*15,00*
		1,38,00

The company passed a resolution to buy back 20% of its equity capital @ ₹ 50 per share. For this purpose, it sold all of its investment for ₹ 22,00,000.

You are required to pass necessary journal entries and prepare the Balance Sheet.

Solution

In the books of Dee Limited

Journal Entries

	Particulars		Dr.	Cr.
			(₹ in '000)	
(i)	Bank Account	Dr.	22,00	
	Profit and Loss Account	Dr.	8,00	
	To Investment Account			30,00
	(Being the investments sold at loss for the purpose of buy back)			

(ii)	Equity Share capital account	Dr.	5,00	
	Premium payable on buy back Account	Dr.	20,00	
	To Equity shares buy back Account			25,00
	(Being the amount due on buy back)			
(iii)	Securities premium Account	Dr.	20,00	
	To Premium payable on buy back Account			20,00
	(Being the premium payable on buy back adjusted against securities premium account)			
(iv)	Revenue reserve Account	Dr.	3,00	
	To Capital Redemption Reserve Account			3,00
	(Being the amount equal to nominal value of equity shares bought back out of free reserves transferred to capital redemption reserve account)			
(v)	Equity shares buy-back Account	Dr.	25,00	
	To Bank Account			25,00
	(Being the payment made on buy back)			

Balance Sheet of Dee Limited as on 1st April, 2012

(After buy back of shares)

Particulars	*Note No*	*(₹ in 000)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	22,00
(b) Reserves and Surplus	2	69,00
(2) Current Liabilities		14,00
Total		10,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		93,00
(2) Current assets		12,00
Total		10,500

Notes to Accounts

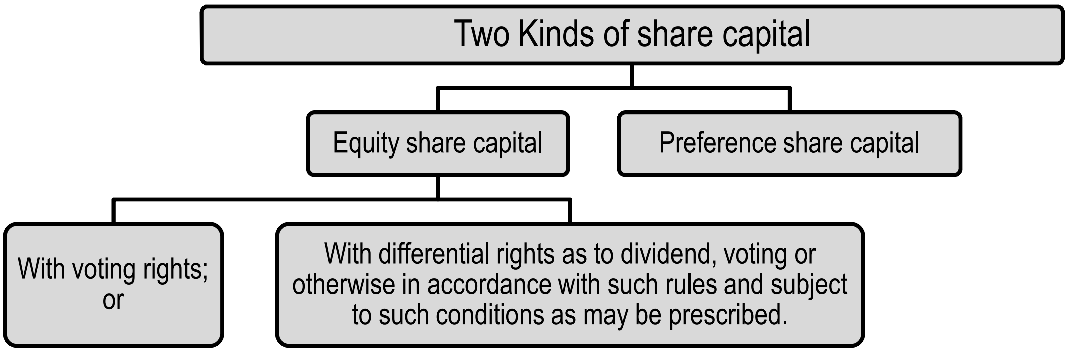
			₹ in 000
1	**Share Capital**		
	Authorised capital:		30,00
	Issued and subscribed capital:		

	2,00,000 Equity shares of ₹ 10 each fully paid up		20,00	
	2,000 10% Preference shares of ₹ 100 each fully paid up		2,00	22,00
2	**Reserves and Surplus**			
	Capital reserve		10,00	
	Capital redemption reserve		3,00	
	Securities Premium	22,00		
	Less: Premium payable on buy back of shares	20,00	2	
	Revenue reserve	30,00		
	Less: Transfer to Capital redemption reserve	3,00	27,00	
	Profit and loss A/c	35,00		
	Less: Loss on investment	8,00	27,00	69,00

1.3 Equity Shares with Differential Rights

The new Companies Amendment Act, 2013 allows companies to issue equity shares with differential rights as to dividend, voting or otherwise in accordance with such rules as may be prescribed.

Section 43 of Companies Act : New issues of share capital to be only of two kinds – the share capital of a company limited by shares shall be only two kinds only, as depicted in the chart given below:–



Summary

- ESOP is an option given to whole-time or other directors, officers or employees of a company to purchase or subscribe the securities offered by the company at a future date, at a predetermined price.
- Buy back of shares can be made out of:

(i) its free reserves; or

(ii) the securities premium account; or

(iii) the proceeds of any shares or other specified securities.

- No company shall purchase its own shares or other specified securities unless—
- The buy back is authorized by the Articles of Association and by a special resolution passed at a general meeting. However, in case the buy back is for a sum less than or equal to ten percent of the paid up equity shares + free reserves the same may be authorized by the resolution of the directors passed at a duly convened Board Meeting.
- the buy-back is or less than or equal to twenty-five per cent of the total paid-up capital and free reserves of the company:
- Partly paid shares cannot be bought back by a company;
- the buy-back of equity shares in any financial year shall not exceed twenty-five per cent of its total paid-up equity capital in that financial year.
- No offer of buy back will be made within a period of one year from the date of closing of the previous buy back if any. Hence, there can be a maximum of one buy back in one year.
- the ratio of the debt owed by the company (both secured and unsecured) is not more than twice the paid up capital and its free reserves after such buy-back:
- As per the new Companies Act 2013 companies can issue equity shares with differential rights subject to the fulfilment of certain conditions. (Section 43).

Unit – 2 : Underwriting of Shares and Debentures

Learning Objectives

After studying this unit, you will be able to

- Learn the provisions of the Companies Act regarding underwriting of shares
- Determine the liability of underwriters whether shares are fully underwritten or partially underwritten
- Account for firm underwriting of shares.

2.1 Introduction

Underwriting an issue of shares or debentures involves entering into a contract with a person known as underwriter, who may be an individual, partnership or company, undertaking that in the event of the shares or debentures not being subscribed by the public or only a part of them being subscribed, he shall take up the balance. In view of the magnitude of such an obligation, issues of shares or debentures are rarely underwritten by one person. They are either underwritten by two or more persons jointly or only a part of the issue is underwritten and, in respect of rest, the company takes the risk of the capital being not subscribed by the public.

2.2 Underwriting Commission

The function of an underwriter has great economic significance. It provides an assurance to the company that it would be able to raise the stipulated amount of capital by the issue of shares or debentures and, on the basis of such an assurance; company can proceed to draw up its investment programme. The Central Government has recently set up a number of financial institutions for helping companies to raise capital. One of the forms in which such a help is rendered is by underwriting the issues of shares and debentures, made by the companies. The prominent institutions that render this service are: Industrial Finance Corporation, Industrial Credit and Investment Corporation of India and Life Insurance Corporation of India.

In consideration of such a service, the underwriter is paid a commission. The Companies Act, 2013 places certain restrictions on the rate of commission and the conditions under which it can be paid. It provides that commission only at a rate authorized by the Articles, not exceeding 2½% of the issue price of debentures and 5% of issue price of shares, can be paid. No commission can be paid in respect of shares or debentures which have not been offered to the general public for subscription.

2.3 Provisions in the Companies Act affecting Underwriting

Disclosure in the Prospectus - According the Companies Act, it is necessary that when any issue of shares or debentures is underwritten, the names of the underwriters and the opinion of the directors that the resources of the underwriters are sufficient to discharge their obligations should be stated.

Disclosure in the Statutory Report - According to clause (6) of the Form prescribed for such a report, a brief description of each underwritten contract should be given and, if any contract has not been carried out fully, the extent to which it has not been carried out and reasons therefore should be stated. In addition, particulars of any commission paid or payable to any Director, Manager, or their associates should be disclosed.

2.4. Underwriting Contract

There are two types of underwriting contract

(i) Normal Underwriting

(ii) Firm Underwriting

2.4.1 Determination of liability in Respect of a Normal Underwriting Contract

2.4.1.1 Determination of liability where whole of the issue has been underwritten by one person: If the whole of the issue has been underwritten by one person, he is responsible to subscribe for all the shares or debentures that have not been subscribed by the public. In such a case, it is not necessary to know the number of applications which had originated through the underwriter and those which had flowed directly to the company.

2.4.1.2 Determination of liability where only part of the issue has been underwritten: In such a case the company is treated as having underwritten the balance of shares which have not been underwritten. In this assumption, the unmarked applications are treated as marked so far as the company is concerned.

Suppose, a company has issued 10,000 shares of which only 6,000 have been underwritten by X; marked applications exceed 6,000. In such a case, X would not be liable to subscribe for any shares. If, however, there are marked applications for only 5,000 shares X would have to subscribe for 1,000 shares provided on his doing so the total number of shares allotted (including those to X) does not exceed 10,000. If it does, the number of shares which X must subscribe will be reduced to that extent.

2.4.1.3 Determination of liability where the whole or part of the issue has been underwritten by two or more underwriters: In the case in which whole or only part of an issue has been underwritten by a number of underwriters, a difficulty may arise in determining the liability of each of the underwriters; such a difficulty may arise in deciding the basis on which the unmarked applications, *i.e.* the applications which have directly flowed to the company should be allocated among the different underwriters. Marked applications are those applications which are received through an underwriter and such applications are to his credit against his overall obligations.

The allocation of unmarked applications to the underwriters can be done in any one of the two ways: according to one method, the unmarked applications are allotted in the proportion of gross amount of capital underwritten; alternatively these are allocated in proportion to the gross amount of capital underwritten as reduced by the marked applications. How the liability of underwriters is determined by following one or the other method, is explained below :

Elahi Buksh & Co. Ltd. issued 10,000 equity shares. These were underwritten as follows:

A	40%	B	35%	C	25%

In all, applications for 8,000 shares were received; applications for 2,000 shares have the stamp of A; those for 1,000 shares that of B, and those for 2,000 shares that of C. There were thus applications for 3,000 shares which did not bear any stamp or which were unmarked. If credit for unmarked applications is given to A, B and C in proportion to their gross liability, the liability of each of the underwriters will be as shown below:

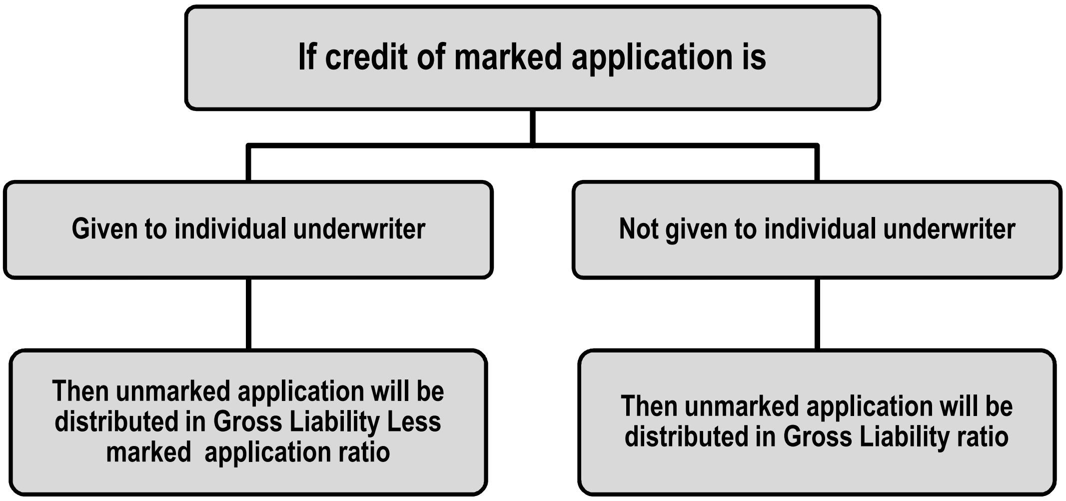
	A	B	C
Gross liability as underwritten	4,000	3,500	2,500
Less: Unmarked applications			
3,000 shares in the ratio of 40:35:25	(1,200)	(1,050)	(750)
Gross Liability of underwriters	2,800	2,450	1,750
Marked applications	2,000	1,000	2,000
Balance	800	1,450	(250)
Credit to A and B for C's surplus (ratio 40:35)	(133)	(117)	250
Actual liability	667	1,333	—

If however, the other view is taken that unmarked applications should be credited to different underwriters in the ratio of liability after credit for marked applications has been given - the position will be as follows :

	A	B	C
Gross liability	4,000	3,500	2,500
Less: marked applications	(2,000)	(1,000)	(2,000)
Liability net of marked applications	2,000	2,500	500
Less: Unmarked applications	(1,200)	(1,500)	(300)
(Shares in ratio of 20:25:5)			
Net liability	800	1,000	200

The liability in this case could also be determined by simply apportioning the total number of shares yet to be subscribed (2,000 in the above case) in the proportion of the balance of the liability after credit for marked forms has been given. Since the liability of each underwriter may vary widely if one or the other method is followed, the underwriting contract should specify the method to be followed.

Note: Students are advised to clarify the position by way of suitable note in the examination.



In case the information as regards the number of applications that are marked and those that are unmarked is not available in the given question, it should be assumed that out of the total number of applications received, a number proportionate to the value of the issue underwritten has been received through the underwriters.

The surplus shown by the particular underwriters is to be credited to the other underwriters in same proportion as for unmarked applications.

Illustration 1

Newton Limited incorporated on 1st January, 2013 issued a prospectus inviting applications for 20,000 equity shares of ₹ 10 each. The whole issue was fully underwritten by Adams, Benzamin and Clayton as follows:

Adams	*10,000 shares*
Benzamin	*6,000 shares*
Clayton	*4,000 shares*

Applications were received for 16,000 shares, of which marked applications were as follows:

Adams	*8,000 shares*
Benzamin	*2,850 shares*
Clayton	*4,150 shares*

You are required to find out the liabilities of individual underwriters.

Solution

Statement of Net Liability of Underwriters

	Gross liability	Marked appli-cations	Number of Unmarked applications in the ratio of gross liability	Shares Total (2) + (3)	Surplus of Clayton in the ratio of 10:6	Total (4)+(5)	Net liability (1)- 6)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Adams	10,000	8,000	500	8,500	219	8,719	1,281
Benzamin	6,000	2,850	300	3,150	131	3,281	2,719
Clayton	4,000	4,150	200	4,350	-350	4,000	–
	20,000	15,000	1,000	16,000	–	16,000	4,000

Note: The applications are for 16,000 shares out of which 15,000 are marked. Hence unmarked applications are for 1,000 shares.

2.4.2 Firm Underwriting

It signifies a definite commitment to take up a specified number of shares irrespective of the number of shares subscribed for by the public. In such a case, unless it has been otherwise agreed, the underwriter's liability is determined without taking into account the number of shares taken up 'firm' by him that is to say, the underwriter is obliged to take up :

(*i*) The number of shares he has applied for 'firm'; and

(*ii*) The number of shares he is obliged to take up on the basis of the underwriting agreement.

In other words, in such cases the obligation or liability of the underwriter is the aggregate of shares to be taken up under firm commitment and the shares as per underwriting commitment.

Let us say, A underwrites 60% of an issue of 10,000 shares and besides applies for 1,000 shares, 'firm'. In case there are marked applications for 4,800 shares he will have to take 2,200 shares, *i.e.* 1,000 shares for which he applied 'firm' and 1,200 shares to meet his liability of underwriting contract. If, on the other hand, the underwriting contract has provided that abatement would be allowed in respect of shares taken up 'firm' the liability of A in the above-mentioned case would only be for 1,200 shares in total.

2.4.2.1 When the Issue is Fully Underwritten [with Firm Underwriting]

There are two alternative ways:

(i) The benefit of firm underwriting is not given to individual underwriter, or

(ii) The benefit of firm underwriting is given to individual underwriter.

(i) The benefit of firm underwriting is not given to individual Underwriter:

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide the resultant in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******
Add: Applications under firm underwriting	******
Total unmarked applications	******

Divide the above calculated unmarked applications in the ratio of **gross liability.**

If the resultant figures of Step 3 are all positive or zero, then it represents **net liability** as per agreement. After this step, go to Step 5 (skip Step 4).

If some of the resultant figures are negative, then continue to Step 4.

Step 4 Add all the negative figures and divide the resultant between the underwriters having positive figures in the ratio of **gross liability.** Repeat Step 4 unless all figures are non-negative. Now these figures represent the **net liability** as per agreement. After this step, to Step 5.

Step 5 Add firm underwriting with the **net liability** as per agreement. The resultant figures represent **total liability.**

Here,

(1) Firm underwriting is treated as unmarked applications and divided in the ratio of gross liability.

(2) The liability of underwriter consists of:

(a) Net liability as per agreement; and

(b) Firm underwriting.

(ii) The benefit of firm underwriting is given to individual underwriter

For determining the liability of individual underwriter, the following steps are followed:

Step 1 Compute gross liability in the usual manner (if it has not been given).

Step 2 Subtract marked applications (excluding firm underwriting) from gross liability of respective underwriters. If some of the resultant figures are found negative, then add all negative figures and divide their sum in the ratio of gross liability.

Step 3 Determine the number of unmarked applications as follows:

Total subscriptions (excluding firm underwriting)	******
Less: Marked applications (excluding firm underwriting)	******
Unmarked applications by public	******

Divide the above calculated unmarked application in the **ratio of gross liability.**

Step 4 Subtract "firm underwriting" of individual underwriter from the respective figures of Step 3.

If the resultant figures of Step 4 are all positive or zero, then that represents net liability as per agreement. After this step, go to Step 6 (skip Step 5).

If some of the resultant figures are negative, then continue to Step 5.

Step 5 Add all negative figures and divide it between the underwriters having positive figures in the ratio of gross liability. Repeat Step 5 unless all figures are non-negative. Now these figures represent the net liability as per agreement. After this step, go to Step 6.

Step 6 Add firm underwriting with the net liability as per agreement. The resultant figures represent total liability.

Here,

(1) Firm underwriting is not treated as unmarked applications.

(2) Firm underwriting is credited to individual underwriters separately.

(3) The liability of Underwriter consists of:

(a) Net liability as per agreement; and

(b) Firm underwriting.

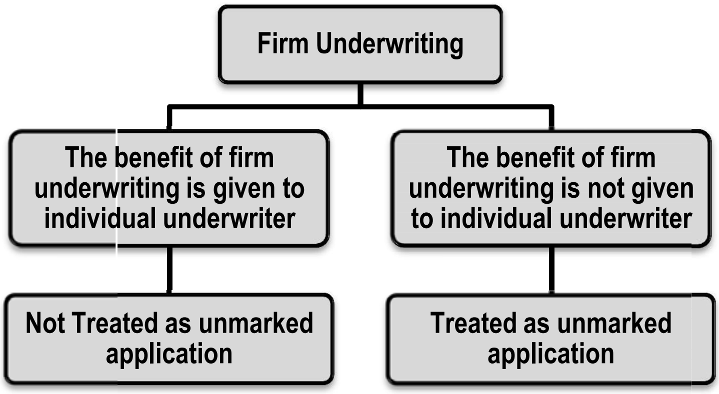


Illustration 2

Rosy Ltd. made a public issue of 4,00,000 equity shares of ₹ 10 each, ₹ 2 payable on application. The entire issue was underwritten by five underwriters as follows: A: 25%, B: 25%, C: 25%, D: 10% and E: 15%. Under the underwriting terms, a commission of 2% was payable on the amount underwritten. Further, the underwriter was at liberty to apply, during the tenure of public issue, for any number of shares in which case he was entitled to a brokerage equal to 1/2% of the par value of shares so applied for.

Applications received were to be analyzed on the basis of rubber stamp of the underwriter, who was to be given credit for the number of applications received bearing his rubber stamp. Applications received which did not bear any rubber stamp were considered as "direct applications" to be credited to all the underwriters in the ratio of their respective underwriting commitment. If, any such credit being given a "surplus" was to result in respect of any underwriter, as compared to his commitment, such surplus was to be distributed amongst the remaining underwriters in the ratio of their respective underwriting commitments.

As a result of the issue the following applications were received:

Bearing rubber stamp of	*A*	*1,02,000 shares*
-Do-	*B*	*95,000 shares*
-Do-	*C*	*60,000 shares*
-Do-	*D*	*32,000 shares*
-Do-	*E*	*51,000 shares*
Not bearing any stamp		*10,000 shares*
		3,50,000 shares

Included in the number of applications mentioned against D in the above table was an application made by D himself for 10,000 shares. The underwriters were informed of the amounts due to or from them, the amounts were duly received or paid.

Show, with the aid of necessary workings, the entries to record the amount so received or paid.

Solution

Journal Entry

		Dr. ₹	Cr. ₹
Bank A/c	Dr.	57,500	
Underwriting commission A/c	Dr.	80,000	
Brokerage on shares A/c	Dr.	500	
To Equity Shares applications A/c			1,00,000
To Bank A/c			38,000

Working Notes: (for description of the columns see below)

Name	1	2	3	4	5	6	7	8	9	10	11	12
A.	1,00,000	1,02,000	2,500	1,04,500	–4,500	1,00,000	—	—	20,000	—	—	20,000
B.	1,00,000	95,000	2,500	97,500	1,500	99,000	1,000	2,000	20,000	—	—	18,000
C.	1,00,000	60,000	2,500	62,500	1,500	64,000	36,000	72,000	20,000	—	52,000	—
D.	40,000	32,000	1,000	33,000	600	33,600	6,400	12,800	8,000	500	4,300	—
E.	60,000	51,000	1,500	52,500	900	53,400	6,600	13,200	12,000	—	1,200	—
	4,00,000	3,40,000	10,000	3,50,000	—	3,50,000	50,000	1,00,000	80,000	500	57,500	38,000

Column No.

(1) Commitment—No. of Shares

(2) Marked Applications

(3) Additional proportionate no. of direct applications or unmarked applicaitons

(4) Total (2) + (3)

(5) Allocation of surplus – done in the ratio of underwriting i.e 25:25:10:15 (B, C, D & E)

(6) Total (4)+(5) – this will be the total credited applications

(7) Final Deficit (1)—(6): Commitment – Total Credited Applicaitons

(8) Amount Receivable from underwriters due @ ₹ 2 per share.

(9) Underwriting Commission due @ 2 % nominal value.

(10) Brokerage due @ 1/2%: Only payable to D for 10,000/- shares applied by him on par value of the shares i.e on Rs 100,000

(11) Due from underwriters.

(12) Due to underwriters.

Illustration 3

Libra Ltd. came up with an issue of 20,00,000 equity shares of ₹ 10 each at par. 5,00,000 shares were issued to the promoters and the balance offered to the public was underwritten by three underwriters Anand, Vijay and Ashok - equally with firm underwriting of 50,000 shares each. Subscriptions totalled 12,97,000 shares including the marked forms which were :

Anand	*4,25,000 shares*
Vijay	*4,50,000 shares*
Ashok	*3,50,000 shares*

The underwriters had applied for the number of shares covered by firm underwriting. The amounts payable on application and allotment were ₹ 2.50 and ₹ 2.00 respectively. The agreed commission was 5%.

Pass summary journal entries for —

(a) The allotment of shares to the underwriters;

(b) The commission due to each of them; and

(c) The net cash paid and or received.

***Note:** Unmarked applications are to be credited to underwriters equally. Benefit of firm underwriting is given to individual underwriter.*

Solution

Libra Ltd.
Journal

		Dr. ₹	Cr. ₹
Bank A/c	Dr.	3,75,000	
To Share Application A/c			3,75,000
(Application money received on firm applications for 50,000 each @ ₹ 2.50 per share from Anand, Vijay & Ashok)			
Anand	Dr.	1,00,000	
Vijay	Dr.	1,00,000	
Ashok	Dr.	3,38,500	
Share Application A/c	Dr.	3,75,000	
To Share Capital A/c			9,13,500
(Allotment of shares to underwriters 50,000 to Anand; 50,000 to Vijay and 1,03,000 to Ashok; application and allotment money credited to share capital)			
Underwriting Commission A/c	Dr.	7,50,000	
To Anand			2,50,000
To Vijay			2,50,000

To Ashok (Amount of underwriting commission payable to Anand, Vijay and Ashok @ 5% on the amount of shares underwritten.)			2,50,000
Bank A/c	Dr.	88,500	
To Ashok (Amount received from Ashok on shares allotted less underwriting commission)			88,500
Anand	Dr.	1,50,000	
Vijay	Dr.	1,50,000	
To Bank A/c (Amount paid to Anand & Vijay in final settlement of underwriting commission due less amount payable on shares allotted payable to him.)			3,00,000

Working Notes :

(1) Calculation of Liability of Underwriters

	Anand	Vijay	Ashok
Gross Liability (No. of shares)	5,00,000	5,00,000	5,00,000
Less : Marked Applications(excluding firm underwriting)	(4,25,000)	(4,50,000)	(3,50,000)
	75,000	50,000	1,50,000
Less : Unmarked Applications (equally)	(24,000)	(24,000)	(24,000)
	51,000	26,000	1,26,000
Less : Firm Underwriting	(50,000)	(50,000)	(50,000)
	1,000	(24,000)	76,000
Surplus of Vijay distributed between Anand & Ashok equally	(12,000)	24,000	(12,000)
	(11,000)	-	64,000-
Surplus of Anand allocated to Ashok totally	11,000	—	(11,000)
	11,000	—	64,000
Less : Adjustment of Anand's surplus	(11,000)	—	(11,000)
Net liability, excluding firm underwriting	—	—	53,000
Add: Firm underwriting	50,000	50,000	50,000
Total liability of underwriters	50,000	50,000	1,03,000

(2) Calculation of Amounts Payable by Underwriters

	Anand	Vijay	Ashok
Liability (No. of shares)	50,000	50,000	1,03,000
Amount payable @ ₹ 4.50 per share	2,25,000	2,25,000	4,63,500
Less : Amount paid on Firm Applications of 50,000 each @ ₹ 2.50	(1,25,000)	(1,25,000)	(1,25,000)

Balance payable	1,00,000	1,00,000	3,38,500
Underwriting Commission Receivable	2,50,000	2,50,000	2,50,000
Amount Paid	1,50,000	1,50,000	—
Amount received by the Co.	—	—	88,500

Illustration 4

A company made a public issue of 1,25,000 equity shares of ₹ 100 each, ₹ 50 payable on application. The entire issue was underwritten by four parties: A, B, C, and D in the proportion of 30% and 25%, 25% and 20% respectively. Under the terms agreed upon, a commission of 2% was payable on the amounts underwritten.

A, B, C, and D also agreed on 'firm'; underwriting of 4,000, 6,000, Nil and 15,000 shares respectively.

The total subscriptions, excluding firm underwriting, including marked applications were for 90,000 shares. Marked applications received were as under :

A 24,000 C 12,000 B 20,000 D 24,000

Ascertain the liability of the individual underwriters and also show the journal entries that you would make in the books of the company. All workings should form part of your answer.

Solution:

When the benefit of firm underwriting is given to individual underwriters.

(i) Total marked applications:

A	B	C	D	
24,000	+20,000	+12,000	+24,000	= 80,000

(ii) Shares subscribed excluding firm underwriting

Total applications	90,000	shares
Less : Marked applications	(80,000)	shares
Unmarked	10,000	

(iii) Statement showing Liability of underwriters

	A	*B*	*C*	*D*	*Total*
Gross liability (30:25:25:20)	37,500	31,250	31,250	25,000	1,25,000
Less : Marked applications	(24,000)	(20,000)	(12,000)	(24,000)	(80,000)
	13,500	11,250	19,250	1,000	45,000
Less : Unmarked (in Gross Ratio)	(3,000)	(2,500)	(2,500)	(2,000)	(10,000)
	10,500	8,750	16,750	–1,000	35,000
Less : Firm underwriting	(4,000)	(6,000)	–	(15,000)	(25,000)
	6,500	2,750	16,750	–16,000	10,000

Less : Surplus of 'D'allotted to A, B & C (30:25:25)	(6,000)	(5,000)	(5,000)	–	–
	500	(2,250)	11,750	–	10,000
Surplus of 'B' allotted	500	–	1,750	–	–
Net liability	–	–	10,000	–	10,000

(iv) Statement of underwriters' liability

Firm	4,000	6,000	–	15,000	25,000
Others	–	–	10,000	–	10,000
	4,000	6,000	10,000	15,000	35,000

(v) Amounts due from underwriters

	A	B	C	D	Total
Shares to be subscribed as per (iv) above	4,000	6,000	10,000	15,000	35,000
Amount due @ ₹ 50 per share	2,00,000	3,00,000	5,00,000	7,50,000	17,50,000
Less : Commission due of shares underwritten	(75,000)	(62,500)	(62,500)	(50,000)	(2,50,000)
	1,25,000	2,37,500	4,37,500	7,00,000	15,00,000

When the benefit of firm underwriting is not given to individual underwriter:

(i) Total marked applications = 24,000+20,000+12,000+24,000 = 80,000

(ii) Shares subscribed excluding 'Firm' underwriting but including

Marked applications	90,000	shares
Add: 'Firm' underwriting	25,000	shares
Total subscription	1,15,000	shares
Less: Marked Applications	(80,000)	shares
Balance being unmarked	35,000	shares

(vi) Check:

(a) Taken by public - unmarked applications	10,000	shares
(b) Public through underwriters - marked	80,000	shares
(c) By underwriters - under agreement	35,000	shares
	1,25,000	shares

Journal Entry

		₹	₹
Bank A/c	Dr	60,00,000	
Underwriting Commission A/c	Dr	2,50,000	
Equity share Application A/c			62,50,000

Illustration 5

Outset Ltd. invited applications from public for 1,00,000 equity shares of ₹ 10 each at a premium of ₹ 5 per share. The entire issue was underwritten by the underwriters P, Q, R and S to the extent of 30%, 30%, 20% and 20% respectively with the provision of firm underwriting of 3,000, 2,000, 1,000 and 1,000 shares respectively. The underwriters were entitled to the maximum commission permitted by law.

The company received applications for 70,000 shares (excluding firm underwriting) from public out of which applications for 19,000, 10,000, 21,000 and 8,000 shares were marked in favour of P, Q, R and S respectively.

Calculate the liability of each underwriter. Also ascertain the underwriting commission payable to different underwriters.

Solution

Calculation of liability of each underwriter assuming that the benefit of firm underwriting is not given to individual underwriters

					(Number of shares)
	P	Q	R	S	Total
Gross Liability	30,000	30,000	20,000	20,000	1,00,000
Less: Marked applications (excluding firm underwriting)	(19,000)	(10,000)	(21,000)	(8,000)	(58,000)
Balance	11,000	20,000	(1,000)	12,000	42,000
Less: Surplus of R allocated to P, Q and S in the ratio of 3:3:2	(375)	(375)	1,000	(250)	-
Balance	10,625	19,625	-	11,750	42,000
Less: Unmarked applications including firm underwriting	(5,700)	(5,700)	(3,800)	(3,800)	(19,000)
Net Liability	4,925	13,925	(3,800)	7,950	23,000
Less: Surplus of R allocated to P, Q and S in the ratio of 3:3:2	(1,425)	(1,425)	3,800	(950)	-
	3,500	12,500	-	7,000	23,000
Add: Firm underwriting	3,000	2,000	1,000	1,000	7,000
Total Liability	6,500	14,500	1,000	8,000	30,000

Calculation of underwriting commission:

As per law in force, underwriting commission is payable @ 5% of the issue price of shares.

Underwriting commission payable to P and Q = 5% of (₹ 15 × 30,000 shares) = ₹ 22,500.

Underwriting commission payable to R and S = 5% of (₹ 15 x 20,000 shares)= ₹ 15,000.

Working Note:

Application received from public	70,000 shares
Add: Shares underwritten firm	7,000 shares
Total application	77,000 shares
Less: Marked applications	(58,000 shares)
Unmarked application including firm underwriting	19,000 shares

Unit – 3 : Redemption of Debentures

Learning Objectives

After studying this unit, you will be able to

- Apply sinking fund method for the redemption of debentures.
- Deal with purchase of own debentures in the open market
- Account for interest on own debentures
- Solve problems based on conversion of debentures

3.1 Introduction

A debenture is a bond issued by a company under its seal, acknowledging a debt and containing provisions as regards repayment of the principal and interest.

Under section 71 (1) of the Companies Act 2013, a company may issue debentures with an option to convert such debentures into shares, either wholly or partly at the time of redemption. Provided that the issue of debentures with an option to convert such debentures into shares, wholly or partly, shall be approved by a special resolution passed at a duly convened general meeting. Section 71 (2) further provides that no company can issue any debentures which carry any voting rights.

Section 71 (4) provides that where debentures are issued by a company under this section, the company shall create a debenture redemption reserve account out of the profits of the company available for payment of dividend and the amount credited to such account shall not be utilized by the company for any purpose other than the redemption of debentures.

Basic provisions

If a charge has been created on any or the entire asset of the company,

- the nature of the charge
- the assets charged

are described therein.

- Since the charge is not valid unless registered with the Registrar, his certificate registering the charge is printed on the bond.
- It is also customary to create a trusteeship in favor of one or more persons in the case of mortgage debentures. The trustees of debenture holders have all powers of a mortgage of a property and can act in whatever way they think necessary to safeguard the interest of debenture holders.

Issue of debentures has been discussed in detail at Common Proficiency Test level. Students are advised to refer the CPT study material chapter 9 for their understanding.

3.2 Redemption of Debentures

Debentures are usually redeemable, but a company may also issue irredeemable debentures.

Redeemable debentures may be **redeemed**

- after a **fixed number** of years or
- any time after a **certain number of years** has elapsed since their issue,
- on giving a **specified notice**, or by **annual drawing**

A company may also purchase its debentures, as and when convenient in the open market and when debentures are quoted at a discount on the Stock Exchange, it may be profitable for the company to purchase and cancel them or, when it is desired, to keep the debentures alive with a view of issuing them again at a later date.

3.3 Debenture Redemption Reserve

A company issuing debentures is required to create a debenture redemption reserve account out of the profits available for distribution of dividend and amounts credited to such account cannot be utilized by the company except for redemption of debentures. Such an arrangement would ensure that the company will have sufficient liquid funds for the redemption of debentures at the time they shall fall due for payment.

Adequacy of Debenture Redemption Reserve (DRR)

Ministry of Corporate Affairs has made the following clarification on adequacy of Debenture Redemption Reserve (DRR) vide Circular no. 04/2013 dated 11 February, 2013:-

		Adequacy of Debenture Redemption Reserve (DRR)
(i)	For debentures issued by All India Financial Institutions (AIFIs) regulated by Reserve Bank of India and Banking Companies for both public as well as privately placed debentures.	No DRR is required
(ii)	For other Financial Institutions (FIs) within the meaning given in the Companies Act.	DRR will be as applicable to NBFCs registered with RBI.
(iii)	For debentures issued by NBFCs registered with the RBI.	25% of the value of debentures issued through public issue. No DRR is required in the case of privately placed debentures.
(iv)	For debentures issued by other companies including manufacturing and infrastructure companies.	25% of the value of debentures issued through public issue. Also 25% DRR is required in the case of

		privately placed debentures by listed companies. For unlisted companies issuing debentures on private placement basis, the DRR will be 25% of the value of debentures.

3.3.1 Liability of the Company to Create Debenture Redemption Reserve

Section 71 (4) in the Companies Act 2013 covers the requirement of creating the Debenture Redemption Reserve. The Section 71 states as follows:

(1) Where a company issues debentures under this section, it shall create a debenture redemption reserve account out of its profits which are available for distribution of dividend every year until such debentures are redeemed.

(2) The amounts credited to the debenture redemption reserve shall not be utitlised by the company except for the purpose aforesaid.

(3) The company referred to in sub-section (1) shall pay interest and redeem the debentures in accordance with the terms and conditions of their issue.

(4) Where a company fails to redeem the debentures on the date of maturity or fails to pay the interest on debentures when they fall due, the Tribunal may, on the application of any or all the holders of debentures or debenture trustee shall, after hearing the parties concerned, direct, by order, the company to redeem the debentures forthwith by the payment of principal and interest due thereon

3.3.2 Balance in Debenture Redemption Reserve (DRR)

The balance to the credit of Debenture Redemption Fund, may in certain circumstances may either be more or less as compared to the amount of debentures which are proposed to be redeemed.

➢ If it is in excess, the amount is transferred to the Capital Reserve, on the assumption that it is a capital profit received on the appreciation in the value of investments or settlement of liability for a lesser amount that what was usually payable.

➢ On the other hand, if it is short, the deficit is made up by the transfer from Profit and Loss Account. The balance in the account, equal to the amount of debentures redeemed is subsequently transferred to General Reserve.

Debentures sometimes are redeemable at a premium. In such a case, the appropriation to the Redemption Reserve Fund should be sufficient to pay both the amount of debentures and the premium on redemption. When the company decides to establish the Debenture Redemption Reserve Account at the end of the first year, the amount indicated by the Debenture Redemption Reserves tables is credited to the Debenture Redemption Reserve account and debited to profit and loss account. That shows the intention of the company to set aside regular sums of money to build up a fund for redeeming debentures. Immediately, the company should also purchase outside investments. The entry for the purpose naturally will be to debit Debenture Redemption Reserve investments and credit bank. It is sometimes thought that since Government securities or individual debentures are available in multiples of ₹ 100 the investments should be made to the nearest of ₹ 100. This may be true in the case of a new issue otherwise, if securities are purchased from the market, it is possible generally to invest any sum of money that may be desired.

In the subsequent years, when interest is received on investments, the bank account will be debited and interest on Debenture Redemption Reserve investments account will be credited. The balance in the latter account will be transferred to the Debenture Redemption Reserve account; the annual instalment will be debited to the profit and loss appropriation account and credited to the Debenture Redemption Reserve account. The investments every year will be of an amount equal to the annual instalment plus the interest which may have been received in the year concerned. Thus, the Debenture Redemption Reserve will go on accumulating each year. [Note : Infact, a notional entry of transfer of interest (and also profit or loss on realisation of Debenture Redemption Reserve investments) to the profit and loss account and then again to Debenture Redemption Reserve will meet strict requirement of law and AS 13 as well.]

Note: It may be stated that the Debenture Redemption Reserve is to be sometimes *non-cumulative*. In that case, interest received on Debenture Redemption Reserve investments will not be credited to Debenture Redemption Reserve nor it will be invested; the amount of the interest will be credited to the profit and loss account.

In the last year, the Debenture Redemption Reserve investments will be realised; the amount will be debited to the bank account and credited to the Debenture Redemption Reserve investments account. If there is any loss or profit, it will be transferred to the Debenture Redemption Reserve account, with the corresponding entry in the Debenture Redemption Reserve investment account. Thus, the amount available by sale of investments will be utilised to pay off the debentures; debentures account will be debited and the bank account credited. The Debenture Redemption Reserve account will still show a big credit balance almost equal to the amount of the debentures. This will be transferred to the general reserve.

Note: Investments may be realised from time to time and debentures may be purchased either for immediate cancellation or as investment as the company pleases. In that case, also the profit or loss on the sale of investments should be transferred to the Debenture Redemption Reserve investment; the interest saved on such debentures should be debited to the debenture interest account and credited to the interest on Debenture Redemption Reserve account directly.

From the accounting point of view, the purchase of debentures involves two problems first, adjustment of the premium or discount, if any paid on their purchase and second, adjustment of interest payable on them. Where a Debenture Redemption Reserve is kept the amount of premium or discount is adjusted therein on cancellation so that at the date of redemption, the balance of the Debenture Investments Account, is equal to the Debenture Account. But, if there is none, Debenture Investments are treated like other investments.

As regards interest, where there is a Debenture Redemption Reserve, the interest on debentures held as an investment made out of the fund is credited to the Debenture Redemption Reserve in exactly the same way as the debentures are outside investments. But where there is no Debenture Redemption Reserve, since the adjustment of interest on debentures held as investments would merely involve crediting and debiting the Profit and Loss Account by the same amount, often it is not made. However, on their purchase or cancellation an amount equal to the nominal value of debentures is transferred to General Reserve from the Profit & Loss Account on the consideration that to such an extent the profits will not be available for distribution.

If the debentures are purchased within the interest period, the price would be inclusive of interest provided these are purchased "cum interest"; but if purchased "ex Interest" the interest to the date of purchase would be payable to the seller in addition. In order to adjust the effect thereof the amount of interest accrued till the date of purchase, if paid, is debited to the Interest Account against which the interest for the whole period will be credited. Thus, in result, a balance in the Account would be left, equal to the interest for the period the debentures were held by the company.

3.3.3 Investment of Debenture Redemption Reserve (DRR) Amount

Every company required to create/maintain DRR shall before the 30th day of April of each year, deposit or invest, as the case may be, a sum which shall not be less than fifteen percent of the amount of its debentures maturing during the year ending on the 31st day of March next following in any one or more of the following methods, namely:

(a) in deposits with any scheduled bank, free from charge or lien;

(b) in unencumbered securities of the Central Government or of any State Government;

(c) in unencumbered securities mentioned in clauses (a) to (d) and (ee) of section 20 of the Indian Trusts Act, 1882;

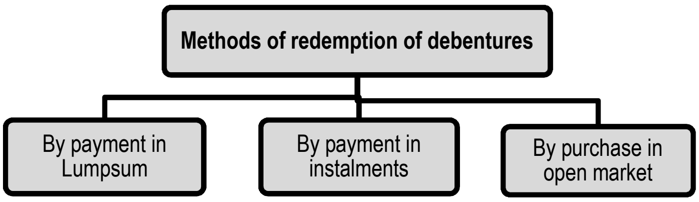
(d) in unencumbered bonds issued by any other company which is notified under clause (f) of section 20 of the Indian Trusts Act, 1882;

The amount deposited or invested, as the case may be, above shall not be utilized for any purpose other than for the repayment of debentures maturing during the year referred to above, provided that the amount remaining deposited or invested, as the case may be, shall not at any time fall below 15 per cent of the amount of debentures maturing during the 31st day of March of that year.

3.4 Methods of Redemption of Debentures

Redemption of debentures must be done according to the terms of issue of debentures and any deviation therefrom will be treated as a default by the company.

Redemption by paying off the debt on account of debentures issued can be done in one of the three methods viz:



3.4.1 By payment in lumpsum

Under payment in lumpsum method, at maturity or at the expiry of a specified period of debenture the payment of entire debenture is made in one lot or even before the expiry of the specified period after passing the necessary resolution at the meeting of debenture holders.

3.4.2 By payment in Instalments

Under payment in installments method, the payment of specified portion of debenture is made in installments as specified intervals.

3.4.3 Purchase of Debentures in Open Market

Debentures sometimes are purchased in open market, where there is a Debenture Redemption Reserve out of the reserve and, if there is none, as a general investment; the Debenture Investment Account or Own Debenture Account is debited.

Suppose a company has issued 8% debentures for ₹ 10,00,000, interest being payable on 31st March and 30th September. The company purchases ₹ 50,000 debentures at ₹ 96 on 1st August 2012. This means that the company will have to pay ₹ 48,000 as principal plus ₹ 1,333 as interest for 4 months.

Entry		₹	₹
Own Debentures	Dr.	48,000	
Interest Account	Dr.	1,333	
To Bank			49,333

It should be noted that even though ₹ 50,000 debentures have been purchased for ₹ 48,000 there is no profit. On purchase of anything, profit does not arise; only on sale, and in this case on cancellation of debentures, will the question of profit or loss could arise.

On 30th September, the company will have to pay ₹ 38,000 as interest to outsiders, *i.e.* 8% on ₹ 9,50,000 for six months. But since the company is keeping the debentures alive, it means, it has saved interest for two months. Therefore, ₹ 667 should be debited to Debentures Interest Account and credited to the Profit and Loss Account. If this entry is passed, it will be noted that the debenture interest account will be debited by the full amount of ₹ 40,000 which is interest for six months on ₹ 10 lakhs. This should be so since in the balance sheet it will be a liability of ₹ 10,00,000. ₹ 50,000 own debentures will be shown on the assets side of the Balance Sheet. However, in the amount column only ₹ 48,000 will be entered.

Suppose out of those debentures ₹ 30,000 is sold at ₹ 98 cum interest on 1st March, 2013 and the remaining ₹ 20,000 is cancelled on 31st March, 2013. The journal entries to be passed will be the following:

		₹	₹
1st March, 2013			
(1) Bank	Dr.	29,400	
To Own Debentures A/c			28,400
To Interest A/c			1,000
(Sale of ₹ 30,000 Debenture @ ₹ 98 cum interest for 5 months credited to Interest A/c the balance being the sale price proper)			
(2) Profit and Loss A/c	Dr.	400	
To Own Debentures A/c			400
(The loss on ₹ 30,000 Own Debentures whose purchase price was ₹ 28,800 at 96)			
31st March, 2013			
8% Debentures A/c	Dr.	20,000	
To Own Debentures A/c			19,200
To Capital Reserve A/c			800
(Cancellation of ₹ 20,000 Debentures)			

It should be noted that the profit on cancellation or redemption of debentures should be treated as a capital profit and, therefore, credited to the capital reserve.

Illustration 1

On January 1, Rama Ltd., had outstanding in its books 500 Debentures of ₹ 100 each interest at 6% per annum. In accordance with the powers in the deed, the directors acquired in the open market Debentures for immediate cancellation as follows :

March 1	*₹ 5,000 at ₹ 98.00 (cum interest)*
Aug. 1	*₹ 10,000 at ₹ 100.25 (cum interest)*
Dec. 15	*₹ 2,500 at ₹ 98.50 (ex-interest)*

Debenture interest is payable half-yearly, on 30th June and 31st Dec.

Show ledger accounts of Debentures, Debenture interest and profit or loss on cancellation, ignoring income-tax.

Solution

6% Debentures Account

1st Half Year

		₹	₹			₹
Mar. 1	To Bank-Debentures Purchased	4,850		Jan. 1	By Balance b/d	50,000
	To Profit & Loss on cancellation of debenture A/c	150	5,000			
June 30	To Balance c/d		45,000			
			50,000			50,000

Profit & Loss on Cancellation of Debentures

June 30	To Capital Reserve (transfer)	₹150	Mar. 1	By Debenture Account	₹150

Debenture Interest Account

		₹		₹
Mar. 1	To Bank-Interest for 2 months on ₹ 5,000 Debentures	50	June 30 By Profit & Loss A/c	1,400
June 30	To Debenture-holders (Interest) A/c	1,350		
		1,400		1,400

Debenture-holders (Interest) Account

		₹			₹
June 30	To Cash	1,350	June 30	By Debenture interest Account (Interest on ₹ 45,000 @ 6% upto 30th June)	1,350

2nd Half Year

6% Debentures Account

		₹	₹			₹
Aug. 1	To Bank-Debenture Purchased		9,975	July 1	By Balance b/d	45,000
	To P & L A/c on Cancellation		25			

Dec. 15	To Bank-Deb. Purchased	2,462.50				
	To Profit & Loss on Cancellation of Debentures	37.50	2,500			
Dec. 31	To Balance c/d		32,500			
			45,000			45,000

Profit & Loss on Cancellation of Debentures Account

		₹			₹
Dec. 31	To Capital Reserve — Transfer	62.50	Aug. 1	By Debenture A/c	25.00
			Dec. 15	By Debenture A/c	37.50
		62.50			62.50

Debenture Interest Account

		₹			₹
Aug. 1	To Bank - Interest for one month on ₹ 10,000	50.00	Dec.	By P & L Account	1,093.75
Dec. 15	To Bank	68.75			
Dec. 31	To Debenture holders	975.00			
		1,093.75			1,093.75

Debenture-holders (Interest) Account

		₹			₹
Dec. 31	To Bank	975.00	Dec. 31	By Debenture Interest (on ₹ 32,500 @ 6% for 6 months)	975.00

Tutorial Notes :

(*i*) Profit or loss on redemption of debenture arises only on sale or cancellation; if debentures are purchased but not cancelled the total amount paid (minus the interest to the date of purchase) should be debited to Own Debentures Account and shown as investment in the Balance Sheet. On cancellation, the account will be credited and Debenture Account debited: the difference between the nominal value of the debentures cancelled and the amount standing to the debit on Own Debentures Account will be profit or loss on redemption of debentures.

(*ii*) If debentures are straightway cancelled on purchase, the profit or loss on redemption of debentures will be ascertained by comparing (*i*) the nominal value of debentures cancelled, and (*ii*) the price paid less interest to the date of purchase (if the transaction is cum-interest).

(*iii*) In case the transaction is ex-interest, the interest to the date of transaction will be paid in addition to the settled price and hence profit on redemption will be nominal value minus the settled price.

Illustration 2

The following balances appeared in the books of a company as on December 31, 2012: 6% Mortgage 10,000 debentures of ₹ 100 each; Debenture Redemption Reserve (for redemption of debentures) ₹ 10, 42,000; Investment ₹ 5,28,000, 4% Government Loan purchased at par and ₹ 5,60,000, 3-1/2% Government paper purchased for ₹ 5,42,000.

The Interest on debentures had been paid up to December 31, 2012.

On February 28, 2013, the investments were sold at ₹ 90 and ₹ 87 respectively and the debentures were paid off at 101, together with accrued interest.

Write up the ledger accounts concerned. The Debenture Redemption Reserve is non cumulative.

Solution

6% Mortgage Debentures Account

2013		₹	2013		₹
Feb. 28	To Debenture-holders A/c	10,00,000	Jan. 1	By Balance b/d	10,00,000

Premium on Redemption of Debentures Account

2013		₹	2013		₹
Feb. 28	To Debenture-holders A/c	10,000	Feb. 28	By D.R.R. A/c	10,000

Debentures Redemption Reserve Investment Account

2013		₹	*2013*		₹
Jan. 1	To Balance b/d	10,70,000	Feb. 28	By Bank ₹ 5,28,000 Govt. Loan @ ₹ 90	4,75,200
				By Bank ₹ 5,60,000 Govt. Paper @ ₹ 87	4,87,200
				By D.R.R. (Loss)	1,07,600
		10,70,000			10,70,000

Debenture Interest Account

2013		₹	2013		₹
Feb. 28	To Cash	10,000	Feb. 28	By Profit & Loss A/c	10,000

Cash Account

2013		₹	2013		₹
Feb.	To Balance b/d	?	Feb. 28	By Debenture-holders	10,10,000
	To Debentures Redemption Reserve investment A/c	9,62,400		By Deb. Interest A/c	10,000
				By Balance c/d	?

Debenture Redemption Reserve Account

2013		₹	2013		₹
Feb.	To D.R.R. Investment Account (Loss)	1,07,600	Jan. 1	By Balance b/d	10,42,000
	To Premium on Redemption of Debentures A/c	10,000		By Profit & Loss (Appropriation) A/c	75,600
	To General Reserve	10,00,000			
		11,17,600			11,17,600

Illustration 3

Sencom Limited issued ₹ 1,50,000 5% Debentures on which interest is payable half yearly on 31st March and 30th September. The company has power to purchase debentures in the open market for cancellation thereof. The following purchases were made during the year ended 31st December, 2012 and the cancellation were made on the following 31st March :

1st March ₹ 25,000 nominal value purchased for ₹ 24,725 ex-interest.

1st September ₹ 20,000 nominal value purchased for ₹ 20,125 cum-interest.

You are required to draw up the following accounts up to the date of cancellation :

(i) Debentures Account;

(ii) Own Debenture Investment Account; and

(iii) Debenture Interest Account.

Ignore taxation and make calculations to the nearest rupee.

Solution

Sencom Limited
Debenture Account

2012		₹	2012		₹
Dec. 31	To Balance c/d	1,50,000	Jan. 1	By Balance b/d	1,50,000
2013			2013		
Mar. 31	To Own Debenture A/c	45,000	Jan. 1	By Balance b/d	1,50,000
	To Balance c/d	1,05,000			
		1,50,000			1,50,000
			April. 1	By Balance b/d	1,05,000

Own Debenture Investment Account

2012		Nominal Cost ₹	Interest ₹	Cost ₹	2012		Nominal Cost ₹	Interest ₹	Cost ₹
Mar. 1	To Bank	25,000	521	24,725	Mar. 31	By Debenture Interest A/c	—	625	—
Sep. 1	To Bank	20,000	417	19,708	Sep. 30	By Debenture Interest A/c	—	1,125	—
Dec. 31	To P & L A/c		1,375		Dec. 31	By Debenture Interest A/c	—	563	—
						By Balance c/d	45,000	—	44,433
		45,000	2,313	44,433			45,000	2,313	44,433
2013					2013				
Jan. 1	To Balance b/d	45,000		44,433	Mar. 31	By Debenture Interest A/c	—	563	—
Mar. 31	To Capital Reserve (Profit on cancellation)	—	—	567		By 5% Deb. A/c	45,000	—	45,000
	To P & L A/c	—	563	—					
		45,000	563	45,000			45,000	563	45,000

Debenture Interest Account

2012		₹	2012		₹
Mar. 31	To Bank (on ₹ 1,25,000 @ 5% for 6 months)	3,125	Jan.	By Accrued Interest (on ₹ 1,50,000 @ 5% for 3 months)	1,875
	To Interest on own Debentures	625	Dec. 31	By P & L A/c	7,500

Sep. 30	To	Bank (on ₹ 1,05,000 @ 5% for 6 months)	2,625				
	To	Interest on own Debentures	1,125				
Dec. 31	To	Interest accrued (on ₹ 1,05,000 for 3 months)	1,312				
	To	Interest on own debentures (on ₹ 45,000 for 3 months)	563				
			9,375				9,375
2013				2013			
Mar. 31	To	Bank (on ₹ 1,05,000 for 6 months)	2,625	Jan. 1	By	Interest Accrued	1,312
	To	Interest on own debentures (on ₹ 45,000 for 3 months)	563	Mar. 31	By	P & L A/c	1,876
			3,188				3,188

Illustration 4

Hindustan Ltd., issued 50,000, 6% Debentures of 100 each on 1st January, 2009. The debentures are redeemable by the creation of a Debenture Redemption Reserve. The company had the right to call upon the Trustee to apply the Debenture Redemption Reserve monies in purchasing own debentures, if available below par. The following information is given :

(a) *The annual appropriation is ₹ 50,000.*

(b) *Debenture Redemption Reserve Balance as on 1st January, 2012 was ₹ 1,31,942 represented by 6% State Loan at cost of ₹ 74,262 (face value ₹ 80,000) and Debenture Redemption Reserve cash ₹ 56,830. This cash balance which includes the annual appropriation of ₹ 50,000 was invested in 6% State Loan. The Loan bond, purchased cum interest, had a face value of ₹ 60,000.*

(c) *1st September, 2012 sold the State Loan of the face value ₹ 40,000 out of loan held on 1st January, 2012 ₹ 38,000 (ex-interest) and the proceeds were applied in purchasing own debentures (face value ₹ 45,000 ex-interest).*

(d) *The debentures purchased are cancelled on 31st December.*

(e) *Interest on State Loan is received on 31st March and 30th September.*

(f) *Interest on debentures is paid on 30th June and 31st December.*

(g) *Debentures outstanding as on 1st January, 2012 were ₹ 4,67,000.*

Make ledger entries in the books of the company to give effect to the above.

Solution

Debenture Redemption Reserve Account

2012		₹	2012		₹
Dec. 31	To General Reserve-transfer	45,000	Jan. 1	By Balance b/d	1,31,942
Dec. 31	To Balance c/d	1,52,761	Sep. 1	By D.R.R. Investment A/c-profit on sale	869
			Dec. 31	By Own Debentures-profit on cancellation	6,450
				By Interest on D.R.R. Investment A/c	8,500
				By Profit & Loss A/c	50,000
		1,97,761			1,97,761
			2013		
			Jan. 1	By Balance b/d	1,52,761

Debenture Redemption Reserve Investment Account 6% State Loan

2012		Face Value ₹	Cost ₹	2012		Face Value ₹	Cost ₹
Jan.1	To Balance b/d	80,000	74,262	Sep.1	By D.R.R. Cash A/c	40,000	38,000
	To D.R.R. Cash A/c	60,000	56,780	Dec. 31	By Balance c/d	1,00,000	93,911
Sep. 1	To D. R. R. A/c, profit on sale (assumed, FIFO basis)		869				
		1,40,000	1,31,911			1,40,000	1,31,911
2013							
Jan.1	To Balance b/d	1,00,000	93,911				

Own Debenture (D.R.R.) Account

2012		₹	₹	2012		₹	₹
Sep. 1	To D.R.R. Cash	45,000	38,550	Dec. 31	By Debentures A/c (cancellation)	45,000	45,000
	To D.R.R. A/c, profit		6,450				
		45,000	45,000			45,000	45,000

Interest on D.R.R. Investment Account

2012		₹	2012		₹
Jan. 1	To Balance b/d (Interest on ₹ 80,000 for 3 months)	1,200	Mar. 31	By D.R.R. Cash (on ₹ 1,40,000 for 6 months)	4,200
Jan. 1	To D.R.R. Cash (on ₹ 60,000 for 3 months)	900	Sep. 1	By D.R.R. Cash (Interest on ₹ 40,000 for 5 months)	1,000
Dec. 31	To D. R. R. A/c, transfer	8,500	Sep. 30	By D.R.R. Cash (Interest on ₹ 1,00,000 for 6 months)	3,000
			Dec. 31	By Debenture Interest (on ₹ 45,000 for 4 months)	900
			Dec. 31	By Balance c/d (on ₹ 1,00,000 for 3 months)	1,500
		10,600			10,600
2013					
Jan. 1	To Balance b/d	1,500			

Debenture Interest Account

2012		₹	2012		₹
June 30	To Bank	14,010	Dec. 31	By P & L A/c, (transfer)	28,020
Sep. 1	To D.R.R. Cash (Interest on ₹ 45,000 Debentures for 2 months)	450			
Dec. 31	To Bank	12,660			
	To Interest on D.R.R. Investment (Interest on own debentures for ₹45,000 for 4 months)	900			
		28,020			28,020

Debenture Redemption Reserve Cash Account

2012		₹	2012		₹
Jan. 1	To Balance b/d	7,680	Jan. 1	By Interest of D.R.R.	

	To	Bank-transfer	50,000			Investment A/c	
Mar. 31	To	Interest on D.R.R. Investments	4,200			(on ₹ 60,000 for 3 months)	900
Sep. 1	To	D.R.R. Investment			By	D.R.R. Investment A/c	
		6% State Loan	38,000			6% State Loan	56,830
	To	Interest on D.R.R. Investments	1,000	Sep. 1	By	Debenture Interest A/c	450
					By	Own Deb. (D.R.R.) A/c	38,500
Sep. 30	To	Interest on D.R.R.		Dec.31	By	Balance c/d	7,200
		Investments	3,000				
			1,03,880				1,03,880
2013							
Jan. 1	To	Balance b/d	7,200				

6% Debentures Account

2012			₹	*2012*			₹
Dec. 31	To	Own Deb. (D.R.R.) A/c	45,000	Jan. 1	By	Balance b/d	4,67,000
Dec. 31	To	Balance c/d	4,22,000				
			4,67,000				4,67,000

Notes :

(1) The amount to be invested on Jan. 1, 2012 is ₹ 57,680; ₹ 60,000, 6% State Loan has been purchased. Interest till date on this loan is ₹ 900; this has been debited to the interest on D.R.R. investments Account and the balance; ₹ 56,780, debited to the D.R.R. Investments Account.

(2) The total amount realised by sale of ₹ 40,000 State loan on Sept. 1, 2012 is ₹ 39,000 *i.e.,* ₹ 38,000 *plus* ₹ 1,000 (interest for 5 months on ₹ 40,000).

(3) ₹ 39,000 is utilised for purchase of ₹ 45,000 own debentures; the interest till date is ₹ 450 — debited to Debenture Interest Account, ₹ 38,550 is debited to Own Debentures (D.R.R.) Account.

Illustration 5

MM Ltd. had the following among their ledger opening balances on January 1, 2012:

	₹
11% Debentures A/c (2000 issue)	*50,00,000*
Debenture Redemption Reserve A/c	*45,00,000*
13.5% Debentures in XX Ltd. A/c (Face Value ₹ 20,00,000)	*19,50,000*
Own Debentures A/c (Face value ₹ 20,00,000)	*18,50,000*

As 31st December, 2012 was the date for redemption of the 2000 debentures, the company started buying own debentures and made the following purchases in the open market :

1-2-2012 2,000 debentures at ₹ 98 cum-interest.

1-6-2012 2,000 debentures at ₹ 99 ex-interest.

Half yearly interest is due on the debentures on the 30th June and 31st December in the case of both the companies.

On 31st December, 2012, the debentures in XX Ltd. were sold for ₹ 95 each ex-interest. On that date, the outstanding debentures of MM Ltd. were redeemed by payment and by cancellation.

Show the entries in the following ledger accounts of MM Ltd. during 2012 :

(a) Debenture Redemption Reserve A/c

(b) Own Debentures A/c

The face value of a debenture was ₹ 100 (Round off calculations to the nearest rupee.)

Solution

(*a*) Debenture Redemption Reserve Account

2012			₹	*2012*			₹
Dec. 31	To	13.5% Deb. in XX Ltd.		Jan. 1	By	Balance b/d	45,00,000
		(Loss on sale of		Dec. 31	By	13.5% Deb. in	
		investment)	50,000			XX Ltd.	2,70,000
	To	General Reserve(transfer)	49,73,000		By	Own Deb. A/c	
						(Int. on own Deb.)	2,53,000
			50,23,000				50,23,000

11% Debentures Account

2012		₹	*2012*		₹
Dec. 31	To Own Debentures A/c	24,00,000	Jan. 1	By Balance b/d	50,00,000

	To Bank	26,00,000			
		50,00,000			50,00,000

(b) **Own Debentures Account**

		Nominal	Int.	Amt.			Nominal	Int.	Amt.
2012		₹	₹	₹	2012		₹	₹	₹
Jan. 1	To Balance b/d	20,00,000	-	18,50,000	June 30	By Debenture			
Feb. 1	To Bank	2,00,000	1,833	1,94,167		Int. A/c		1,32,000	
June 1	To Bank	2,00,000	9,167	1,98,000	Dec. 31	By Debenture			
Dec. 31	To Capital Res.					Int. A/c		1,32,000	
	(profit on					By 11% Deb	24,00,000		
	cancellation)			1,57,833		Account, cancellation			24,00,000
	To. Deb. Redemp Reserve		2,53,000						
		24,00,000	2,64,000	24,00,000			24,00,000	2,64,000	24,00,000

Working Note :

13.5% Debentures in XX Ltd.

		Interest	Amount			Interest	Amount
2012		₹	₹	2012		₹	₹
Jan. 1	To Balance b/d			June 30	By Bank	1,35,000	
	(20,00,000)		19,50,000	Dec. 31	By Bank	1,35,000	
Dec. 31	To Debenture				By Bank		19,00,000
	Redemp. Reserve	2,70,000			By Debenture Redemp.		
					Reserve		
					(Loss on sale)		50,000
		2,70,000	19,50,000			2,70,000	19,50,000

Illustration 6

(i) *Swati Associates Ltd. has issued 10,000 12% Debentures of ₹ 100 each on 1-1-2010. These debentures are redeemable after 3 years at a premium of ₹ 5 per debenture. Interest is payable annually.*

(ii) *On October 1, 2011, it buys 1,500 debentures from the market at ₹ 98 per debenture. These are sold away on June 30, 2012 at ₹ 105 per debenture.*

(iii) *On January 1, 2012 it buys 1,000 debentures at ₹ 104 per debenture from the open market. These are cancelled on April 1, 2012.*

(iv) *On October 1, 2012 it buys 2,000 debentures at ₹ 106 per debenture from the open market. These debentures along with other debentures are redeemed on 31st December, 2012.*

Prepare the relevant Ledger Accounts showing the above transactions. Workings should form part of your answer.

Solution

12% Own Debentures Account

2011		Interest ₹	Amount ₹	2011		Interest ₹	Amount ₹
Oct. 1	To Bank (₹ 1,50,000)	13,500	1,47,000	Dec. 31	By Debenture Int. A/c	18,000	
	To Profit & Loss A/c	4,500			By Balance c/d		1,47,000
		18,000	1,47,000			18,000	1,47,000
2012				2012			
Jan. 1	To Balance b/d		1,47,000	Apl. 1	By Debenture Int. A/c	3,000	
Jan. 1	To Bank		1,04,000		By 12% Deb. A/c		1,00,000
Apl. 1	To Profit & Loss A/c	3,000			By Profit & Loss A/c		4,000
June 30	To Profit & Loss A/c	9,000	10,500	June 30	By Bank	9,000	1,57,500
Oct. 1	To Bank (₹ 2,00,000)	18,000	2,12,000	Dec. 31	By Deb. Int. A/c	24,000	
Dec.31	To Profit & Loss A/c	6,000			By 12% Deb. A/c (cancelled)		2,00,000
					By Profit & Loss A/c		12,000
		36,000	4,73,500			36,000	4,73,500

Note : It has been assumed that all transactions are ex-interest. The amount of such interest has been calculated from the previous 1st January to the date of transaction since the interest is payable annually.

Debenture Interest Account

2010		₹	*2010*		₹
Dec. 31	To Bank A/c	1,20,000	Dec. 31	By Profit & Loss A/c	1,20,000
2011			2011		
Dec. 31	To Bank A/c	1,02,000	Dec. 31	By Profit & Loss A/c	1,20,000
	To Int. on Own Deb. A/c	18,000			
		1,20,000			1,20,000
2012			2012		
Apl.1	To Int. on Own Deb. A/c	3,000	Dec. 31	By Profit & Loss A/c	1,11,000
Dec. 31	To Int. on Own Deb. A/c	24,000			

	To Bank A/c (12% on ₹ 7,00,000)	84,000			
		1,11,000			1,11,000

Statement of Profit & Loss (Extracts) for the year 2010

Particulars	*Notes*	*Amount*
Expenses		
Finance costs	xx	1,20,000
Total expenses		……
Notes to accounts		
xx. Finance costs		
Interest on debenture		1,20,000

Statement of Profit & Loss (Extracts) for the year 2011

Particulars	*Notes*	*Amount*
Other Income	xx	4,500
Total Revenue		……
Expenses		
Finance costs	xxx	1,20,000
Total expenses		……
Notes to accounts		
xx. Other Income		
Int. on Own Deb. A/c (18,000 - 13,500)		4,500
xxx. Finance costs		
Interest on debenture		1,20,000

Statement of Profit & Loss (Extracts) for the year 2012

Particulars	*Notes*	*Amount*
Other Income	xx	28,500
Total Revenue		
Expenses		
Finance costs	xxx	51,000
Total expenses		
Notes to accounts		
xx. Other Income		
Int. on Own Deb. A/c (36,000 - 18,000)		18,000
Profit on cancellation of debentures		10,500
Total		**28,500**

xxx. Finance costs		
Loss on cancellation of debentures (4,000 + 12,000)		16,000
Premium on redemption of debentures (₹ 7,00,000 @ 5%)		35,000
Total		**51,000**

Premium on Redemption of Debentures A/c

2010			2010		
Dec. 31	To Bank	35,000	Dec. 31	By Profit & Loss A/c	35,000

12% Debentures Account

2010		₹	2010		₹
Dec. 31	To Balance c/d	10,00,000	Jan. 1	By Bank	10,00,000
2011			2011		
Dec. 31	To Balance c/d	10,00,000	Jan. 1	By Balance b/d	10,00,000
2012			2012		
Apl. 1	To Own Deb. A/c	1,00,000	Jan. 1	By Balance b/d	10,00,000
Dec. 31	To Own Deb. A/c	2,00,000			
	To Bank	7,00,000			
		10,00,000			10,00,000

Working Notes :

(*i*) Interest paid on purchase of own debentures:

Date	*Nominal Amount*	*Period*	*Rate*	*Interest*
2011 Oct. 1	₹ 1,50,000	9 months	12%	13,500
2012 Oct. 1	₹ 2,00,000	9 months	12%	18,000

(*ii*) Interest credited to Interest on Own Debenture A/c

2011 Dec. 31	₹ 1,50,000	12 months	12%	18,000
2012 April 1	₹ 1,00,000	3 months	12%	3,000
2012 June 30	₹ 1,50,000	6 months	12%	9,000
2012 Dec. 31	₹ 2,00,000	12 months	12%	24,000

(*iii*) Profit/Loss on cancellation/sales is difference between cost or nominal value and sales price.

Illustration 7

The Summary Balance Sheet of Chanjit Ltd. at March 31, 2012 was :

	₹		₹
Issued and Fully Paid Share Capital :		*Sundry Assets*	*21,55,000*
		Own Debentures (Nominal	*1,05,000*

		₹ 1,20,000)	
50,000 6%Redeemable 'A' Pref. Shares of ₹ 10 each	*5,00,000*	*Cash at Bank*	*5,80,000*
40,000 7% Redeemable 'B' Pref. Shares of ₹ 10 each (less calls in arrear on 5,000 shares@ ₹ 1)	*3,95,000*		
50,000 Equity shares of ₹ 10 each	*5,00,000*		
Securities Premium Account	*1,00,000*		
Capital Reserve Account	*1,00,000*		
Profit and Loss Account	*4,00,000*		
General Reserve Account	*2,00,000*		
5% Debentures	*4,00,000*		
Trade Payables	*2,45,000*		
	28,40,000		*28,40,000*

On September 30, 2012 following were due for redemption :

(1) The ₹ 4,00,000 5% Debentures at a premium of 10 per cent.

(2) The ₹ 5,00,000 6% 'A' Preference Shares at a premium of ₹ 1 per share.

(3) The ₹ 4,00,000 7% 'B' Preference Shares at a premium of 5 per cent.

It was decided :

(a) Out of the trading profits of ₹ 2,00,000 earned in the seven months to Oct. 31, 2012, to pay the debenture interest and preference dividends for the half year to September 30, 2012;

(b) to offer to the debenture holders new 6% debentures 2012 or repayment in cash. The offer of new debentures in exchange for the original holding was accepted by 50 per cent of the debenture holders including those held by Chanjit Ltd. The whole transaction was completed on September 30, 2012;

(c) A transfer was made to General Reserve of a sum equivalent to the nominal value of redemption;

(d) to make an issue of 60,000 Equity Shares of ₹ 10 each at a premium of ₹ 2.50 per share. This was done on August 31, 2012 and all moneys were received on that date;

(e) to repay in cash both 'A' and 'B' Preference shares, and this was carried through on September 30, 2012.

You are required to (1) show the ledger accounts recording the above transaction in the company books and (2) give the company's Balance Sheet at Oct. 31, 2012. Ignore expenses and taxation.

Solution:

5% Debentures Account

2012		₹	2012		₹
Sep. 30	To Debenture holders Account	4,00,000	Apl. 1	By Balance b/d	4,00,000
		4,00,000			4,00,000

Old 5% Own Debentures Account

2012		₹	2012		₹
Apl. 1	To Balance b/d	1,05,000	Sep. 30	By New Own 6% Deb. A/c (nominal value ₹1,32,000)	1,05,000

(New) 6% Own Debentures Account

2012		₹	2012		₹
Sep. 30	To (Old) 5% Own Deb. A/c	1,05,000	Sep. 30	By Balance c/d	1,05,000
		1,05,000			1,05,000

6% Debentures Account

2012		₹	2012		₹
Oct. 31	To Balance c/d	2,20,000	Sep. 30	By Debentures A/c	2,20,000
		2,20,000			2,20,000

Debenture holders Account

2012		₹	2012		₹
Sep. 30	To Bank A/c	2,20,000	Sep. 30	By 5% Debentures A/c	4,00,000
	To 6% Debentures	2,20,000		By Premium on Redemp. of Debentures A/c	40,000
		4,40,000			4,40,000

General Reserve Account

2012		₹	2012		₹
Oct. 31	To Balance c/d	4,00,000	Apl. 1	By Balance b/d	2,00,000
			Sep. 30	By Profit & Loss A/c	2,00,000
		4,00,000			4,00,000
			Nov. 1	By Balance b/d	4,00,000

Statement of Profit & Loss (Extract) for the year 2012

Other income	x	3,000
Total		…….
Expenses:		
Finance Costs	Xx	10,000
Total expenses		……
Profit/ (Loss) for the period (200,000-7,000)		**1,93,000**
Notes to accounts		
x Other income		
Interest on own debentures		3,000
xx Finance costs		
Interest on 5% Debentures		10,000

Note : It has been assumed that cash balance has increased by the sum of profit earned.

Equity Share Capital Account

2012		₹	2012		₹
Oct. 31	To Balance c/d	11,00,000	Apl. 1	By Balance b/d	5,00,000
			Aug. 31	By Bank A/c	6,00,000
		11,00,000			11,00,000
			Nov. 1	By Balance b/d	11,00,000

Securities Premium Account

2012		₹	2012		₹
Sep. 30	To Premium on Redemp. of Preference Shares A/c	70,000	Apl. 1	By Balance b/d	1,00,000
			Aug. 30	By Bank A/c	1,50,000
	To Premium on Redemp. of Debentures A/c	40,000			
	To Balance c/d	1,40,000			
		2,50,000			2,50,000
			Nov. 1	By Balance b/d	1,60,000

Cash at Bank

2012		₹	2012		₹
Apl. 1	To Balance b/d	5,80,000	Sep. 30	By 6% 'A' Preference Shareholders A/c	5,50,000
Aug. 31	To Equity Share Capital A/c	6,00,000		7% 'B' Preference Shareholders A/c	3,67,500
	To Securities Premium A/c	1,50,000			
Oct. 31	To Profit & Loss A/c	2,00,000			

	(assumed to be earned in cash)			By 5% Debentureholders Account	2,20,000
				By Pref. Dividend A/c	29,000
				By Interest on 5% Deb. A/c (10,000-3,000)	7,000
			Oct. 31	By Balance c/d	3,56,500
		15,30,000			15,30,000
Nov.1	To Balance b/d	3,56,500			

7% 'B' Preference Shareholders Account

2012		₹	2012		₹
Sep. 30	To Bank A/c	3,67,500	Sep. 30	By 7% 'A' Preference Shares Capital A/c (35,000 shares)	3,50,000
				By Premium on Redemp. of Pref. Shares A/c	17,500
		3,67,500			3,67,500

6% 'A' Preference Shareholders Account

2012		₹	2012		₹
Sep. 30	To Bank A/c	5,50,000	Sep. 30	By 6% 'A' Preference Share Capital A/c	5,00,000
				By Premium on Redemp. of Pref. Shares A/c	50,000
		5,50,000			5,50,000

Premium on Redemption of Preference Shares Account

2012		₹	2012		₹
Sep. 30	To 6% 'A' Pref. Shareholders Account	50,000	Sep.30	By Securities Premium A/c	70,000
	To 7% 'B' Pref. Shareholders Account	17,500			
	To Balance c/d	2,500			
		70,000			70,000
			Oct. 1	By Balance b/d	2,500

Premium on Redemption of Debentures Account

2012		₹	2012		₹
Sep. 30	To 5% Debentureholders	20,000	Sep. 30	By Securities Premium A/c	20,000

Capital Redemption Reserve Account

2012		₹	2012		₹
Oct. 31	To Balance c/d	3,00,000	Sep. 30	By Profit & Loss A/c	3,00,000
			Nov. 1	By Balance b/d	3,00,000

Balance Sheet of Chanjit Ltd. as on 31st Oct., 2012

Particulars	Note No	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	11,45,000
(b) Reserves and Surplus	2	10,04,000
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	2,20,000
(3) Current Liabilities		
(a) Trade payables		2,45,000
(b) Short-term provisions	4	2,500
Total		26,16,500
II. Assets		
(1) Non-current assets		
(a) Fixed assets		21,55,000
(b) Non-current investments	5	1,05,000
(2) Current assets		
Cash and Cash equivalents		3,56,500
Total		26,16,500

Notes to Accounts

			₹
1	**Share Capital**		
	Authorised, Issued and Subscribed		
	1,10,000 Equity Shares of ₹ 10 each fully paid up		11,00,000

	7% Redeemable 'B' Pref. Shares (pending redemption)	50,000	
	Less : Calls in arrear	(5,000)	45,000
			11,45,000
2	**Reserve and Surplus**		
	Capital Reserve		1,00,000
	Capital Redemption Reserve A/c		3,00,000
	Securities Premium		1,40,000
	General Reserve		4,00,000
	Profit & Loss Account	1,93,000	
	Add: Balance from previous year	4,00,000	
		5,93,000	
	Less: Preference Dividend	29,000	
	Transfer to General Reserve	(2,00,000)	
	Transfer to Capital Redemption Reserve	(3,00,000)	
	Profit (Loss) carried forward to Balance Sheet		64,000
			10,04,000
3	**Long-term borrowings**		
	Secured Loans : 6% Debentures		2,20,000
4	**Short-term provisions**		
	Premium payable on redemption of 5,000 B Preference Shares		2,500
5	**Non-current investments**		
	Own Debenture (Nominal Value 1,32,000)		1,05,000

Illustration 8

The Summary Balance Sheet of BEE Co. Ltd. on 31st March, 2012 read as under :

Liabilities	*₹*	*Assets*	*₹*
Share Capital :		*Freehold property*	*1,15,000*
Authorised:		*Stock*	*1,35,000*
30,000 Equity Shares of ₹ 10 each	*3,00,000*	*Trade receivables*	*75,000*
Issued and Subscribed:		*Cash*	*30,000*
20,000 Equity Shares of ₹ 10 each		*Balance at Bank*	*2,20,000*
fully paid	*2,00,000*		
Profit and Loss Account	*1,20,000*		
12% Debentures	*1,20,000*		

Trade payables	*1,15,000*		
Proposed Dividends	*20,000*		
	5,75,000		*5,75,000*

At the Annual General Meeting it was resolved :

(a) To pay the proposed dividend of 10 per cent in cash.

(b) To give existing shareholders the option to purchase one ₹ 10 share at ₹ 15 for every four shares (held prior to the bonus distribution), this option being taken up by all shareholders.

(c) To issue one bonus share for every four shares held.

(d) To repay the debentures at a premium of 3 per cent.

Give the necessary journal entries and the company's Balance Sheet after these transactions are completed.

Solution

Journal of BEE Co. Ltd.

		Dr. ₹	Cr. ₹
Proposed Dividend A/c	Dr.	20,000	
To Bank A/c			20,000
(Proposed Dividend paid to existing shareholders)			
Bank A/c	Dr.	75,000	
To Equity Shareholders A/c			75,000
(Application money received on 5,000 shares @ ₹ 15 per share to be issued as rights shares in the ratio of 1:4)			
Equity Shareholders A/c	Dr.	75,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			25,000
(Share application money on 5,000 shares @ ₹ 10 per share transferred to Share Capital Account, and ₹ 5 per share to Securities Premium Account vide Board's Resolution dated….)			
Securities Premium A/c	Dr.	25,000	
Profit & Loss A/c	Dr.	25,000	
To Bonus to Shareholders A/c			50,000
(Amount transferred for issue of bonus shares to existing shareholders in the ratio of 1:4 *vide* General Body's resolution dated...)			

Bonus to Shareholders A/c	Dr.	50,000	
To Equity Share Capital A/c			50,000
(Issue of bonus shares in the ratio of 1 for 4 *vide* Board's resolution dated....)			
12% Debentures A/c	Dr.	1,20,000	
Premium Payable on Redemption A/c	Dr.	3,600	
To Debenture holders A/c			1,23,600
(Amount payable to debentures holders)			
Profit & Loss A/c	Dr.	3,600	
To Premium Payable on Redemption A/c			3,600
(Premium payable on redemption charged to Profit & Loss A/c)			
Debenture holders A/c	Dr.	1,23,600	
To Bank A/c			1,23,600
(Amount paid to debenture holders on redemption)			

Balance Sheet of BEE Co. Ltd. as on...... (after completion of transactions)

Particulars	Note No	₹
I. Equity and liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	3,00,000
(b) Reserves and Surplus	2	91,400
(2) Current Liabilities		
(a) Trade payables		1,15,000
Total		5,06,400
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible Assets	3	1,15,000
(2) Current assets		
(a) Inventories		1,35,000
(b) Trade receivables		75,000
(c) Cash and cash equivalents	4	1,81,400
Total		5,06,400

Notes to Accounts

			₹
1.	**Share Capital**		
	30,000 shares of ₹ 10 each fully paid (5,000 shares of ₹ 10 each, fully paid issued as bonus shares out of securities premium and P&L Account)		3,00,000
2.	**Reserve and Surplus**		
	Profit & Loss Account (1,20,000 – 3,600)	1,16,400	
	Less: Utilisation for issue of bonus shares	(25,000)	91,400
3.	**Tangible assets**		
	Freehold Property		1,15,000
4.	**Cash and cash equivalents**		
	Cash at Bank	1,51,400	
	Cash in Hand	30,000	1,81,400

Note : The number of bonus shares issued has been calculated on the basis of issued capital before rights issued *i.e.,* 20,000 shares (and not 25,000 shares after rights issue).

Illustration 9

The summarised Balance Sheet of Convertible Limited, as on 30th June, 2012, stood as follows:

Liabilities	*₹*
Share Capital : 5,00,000 equity shares of ₹ 10 each fully paid	*50,00,000*
General Reserve	*75,00,000*
Debenture Redemption Reserve	*50,00,000*
13.5% Convertible Debentures, 1,00,000 Debentures of ₹ 100 each	*1,00,00,000*
Other loans	*50,00,000*
Current Liabilities and Provisions	*1,25,00,000*
	4,50,00,000
Assets :	
Fixed Assets (at cost less depreciation)	*1,60,00,000*
Debenture Redemption Reserve Investments	*40,00,000*
Cash and bank Balances	*50,00,000*
Other Current Assets	*2,00,00,000*
	4,50,00,000

The debentures are due for redemption on 1st July, 2012. The terms of issue of debentures provided that they were redeemable at a premium 5% and also conferred option to the *debenture holders to convert 20% of their holding into equity shares at a predetermined price of ₹ 15.75 per share and the payment in cash.*

Assuming that :

(i) except for 100 debenture holders holding totally 25,000 debentures, the rest of them exercised the option for maximum conversion.

(ii) the investments realise ₹ 44 lakhs on sale; and

(iii) all the transactions are put through, without any lag, on 1st July, 2012.

Redraft the balance sheet of the company as on 1st July, 2012 after giving effect to the redemption. Show your calculations in respect of the number of equity shares to be allotted and the cash payment necessary.

Solution

Convertible Limited
Balance Sheet as on July 1, 2012

Particulars	Note No	Figures as at the end of current reporting period
		₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	60,00,000
(b) Reserves and Surplus	2	1,29,75,000
(2) Non-Current Liabilities		
(a) Long-term borrowings - Unsecured Loans		50,00,000
(3) Current Liabilities		
(a) Short-term provisions		1,25,00,000
Total		3,64,75,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets		1,60,00,000
(2) Current assets		
(a) Cash and cash equivalents		4,75,000
(b) Other current assets		2,00,00,000
Total		3,64,75,000

Notes to Accounts

			₹
1.	**Share Capital**		
	6,00,000 Equity Shares of ₹ 10 each		60,00,000
2.	**Reserves and Surplus**		
	General Reserve	75,00,000	
	Add : Debenture Redemption Reserve transfer	50,00,000	
		1,25,00,000	
	Add: Profit on sale of investments	4,00,000	
		1,29,00,000	
	Less : Premium on redemption of debentures	(5,00,000)	1,24,00,000
	Securities Premium Account		5,75,000
			1,29,75,000

Working Notes :

(i) Calculation of number of shares to be allotted :

Total number of debentures	1,00,000
Less : Number of debentures not opting for conversion	(25,000)
	75,000
20% of 75,000	(15,000)
Redemption value of 15,000 debentures	₹ 15,75,000

Number of Equity Shares to be allotted :

$= \frac{15,75,000}{15.75}$ = 1,00,000 shares of ₹ 10 each.

(ii) Calculation of cash to be paid :

	₹
Number of debentures	1,00,000
Less : number of debentures to be converted into equity shares	(15,000)
	85,000
Redemption value of 85,000 debentures (85,000 × ₹ 105)	₹ 89,25,000

(iii) Cash and Bank Balance :

Balance before redemption	50,00,000
Add : Proceeds of investments sold	44,00,000
	94,00,000
Less : Cash paid to debenture holders	(89,25,000)
	4,75,000

Note : The premium on redemption of debentures can also be adjusted against Securities Premium Account.

Summary

- Debenture creates a charge against some or all the assets of the company.
- Charge may be fixed or floating, depends upon the condition of issue.
- Debentures may be redeemed after a fixed number of years or after a certain period has elapsed.
- For redemption of Debentures a company shall maintain Debenture Redemption Reserve

Unit – 4 : Amalgamation and Reconstruction

Learning Objectives

- After studying this unit, you will be able to solve the advanced problems on amalgamation and reconstruction of companies

4.1 Amalgamation

In an amalgamation, two or more companies are combined into one by merger or by one taking over the other. Therefore, the term 'amalgamation' contemplates two kinds of activities:

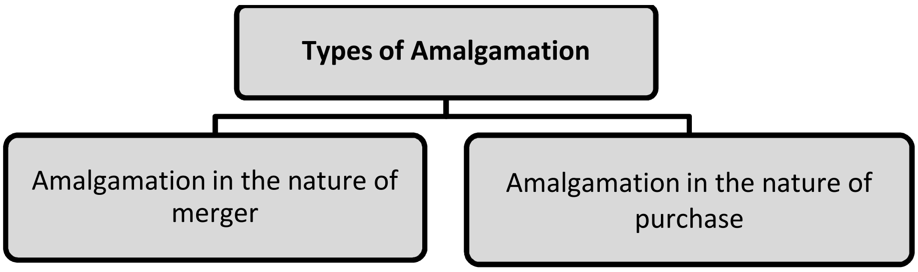
(*i*) two or more companies join to form a new company or

(*ii*) absorption and blending of one by the other.

Thus, amalgamations include absorption.

4.1.1 Types of Amalgamation

The Companies Act, 2013* has not specifically defined the term 'amalgamation' although it covers mergers and amalgamations in section 232 under the chapter XV on Compromises, Arrangements and Amalgamations. However, from several legal decisions, the definition of amalgamation may be inferred. The Institute of Chartered Accountants of India has introduced Accounting Standard -14 (AS 14) on 'Accounting for Amalgamations'. The standard recognizes two types of amalgamation –



4.2 Reconstruction

Reconstruction is a process by which affairs of a company are reorganized by revaluation of assets, reassessment of liabilities and by writing off the losses already suffered by reducing the paid up value of shares and/or varying the rights attached to different classes of shares. The object of reconstruction is usually to reorganize capital by writing off unrepresentative value of assets, restructure its capital needs under a rehabilitation plan and fund the same

***** *It may be noted that most of the sections related with corporate restructuring have not been notified till 31st May, 2015. Therefore, the corresponding sections of the companies Act, 1956 are still applicable at present.***

accordingly, settle dues with creditors by driving discounts and cuts and to effect economies in operations. Such a process is called ***internal reconstruction*** which is carried out without liquidating the company and forming a new one.

The other process of amalgamating the company or merge it with another under a scheme of reconstruction and rehabilitation is called ***External Reconstruction***

You must have studied the concepts of amalgamation and reconstruction of companies in Chapters 5 and 6 in Paper 1 Accounting of Intermediate (IPC) Course – Group I. In this unit, we will deal with some advanced problems for advanced knowledge on the topic.

4.3 Advanced Problems

Amalgamation of Companies

Illustration 1

Following are the summarised Balance Sheets of A Ltd. and B Ltd. as at 31.3.2012:

Particulars	A Ltd.	B Ltd.
Share capital: Equity shares 10 each (fully paid up)	10,00,000	6,00,000
Securities premium	2,00,000	----
General reserve	3,00,000	2,50,000
Profit and loss account	1,80,000	1,60,000
10% Debentures	5,00,000	----
Secured loan	-----	3,00,000
Trade payables	2,60,000	1,70,000
	24,40,000	14,80,000
Land and building	9,00,000	4,50,000
Plant and machinery	5,00,000	3,80,000
Investment	80,000	----
Inventory	5,20,000	3,50,000
Trade receivables	4,10,000	2,60,000
Cash at bank	30,000	40,000
	24,40,000	14,80,000

The companies agree on a scheme of amalgamation on the following terms:

(i) A new company is to be formed by name AB Ltd.

(ii) AB Ltd. to take over all the assets and liabilities of the existing companies.

(iii) For the purpose of amalgamation, the shares of the existing companies are to be valued as under:

A Ltd. = ₹ 18 per share

B Ltd. = ₹ 20 per share

(iv) A contingent liability of A Ltd. of ₹ 60,000 is to be treated as actual existing liability.

(v) The shareholders of A Ltd. and B Ltd. are to be paid by issuing sufficient number of shares of AB Ltd. at a premium of ₹ 6 per share.

(vi) The face value of shares of AB Ltd. are to be of ₹ 10 each.

You are required to:

(i) Calculate the purchase consideration (i.e., number of shares to be issued to A Ltd. and B Ltd.).

(ii) Pass journal entries in the books of A Ltd. for the transfer of assets and liabilities.

(iii) Pass journal entries in the books of AB Ltd. for acquisition of A Ltd. and B Ltd.

(iv) Prepare the Balance Sheet of AB Ltd.

Answer

(i) Statement showing calculation of purchase consideration

	(Number of shares)	
	A Ltd.	*B. Ltd.*
Existing shares	1,00,000	60,000
Value per share	₹ 18	₹ 20
Total value	₹ 18,00,000	₹ 12,00,000
No. of shares to be issued at a premium of ₹ 6 per share i.e. ₹ 16 (10+6)	1,12,500 shares	75,000 shares
	₹	₹
Share capital	11,25,000	7,50,000
Add: Securities premium	6,75,000	4,50,000
Total purchase consideration	18,00,000	12,00,000

(ii) Journal Entries in the books of A Ltd.

		₹	₹
Realisation A/c	Dr.	24,40,000	
To Land & building			9,00,000
To Plant & machinery			5,00,000
To Inventory			5,20,000
To Trade receivables			4,10,000
To Investment			80,000
To Bank			30,000
(Being assets transferred to Realisation A/c)			
Profit and loss A/c	Dr.	60,000	
ToTrade payables			60,000
(Being contingent liability treated as real liability)			

10% Debentures A/c	Dr.	5,00,000	
Trade payables A/c	Dr.	3,20,000	
To Realisation A/c			8,20,000
(Being transfer of liabilities to Realisation A/c)			
AB Ltd.	Dr.	18,00,000	
To Realisation A/c			18,00,000
(Being the purchase consideration accounted for)			
Share in AB Ltd. A/c	Dr.	18,00,000	
To AB Ltd.			18,00,000
(Being purchase consideration received)			
Share Capital A/c	Dr.	10,00,000	
Securities premium A/c	Dr.	2,00,000	
General Reserve A/c	Dr.	3,00,000	
Profit and Loss A/c	Dr.	1,20,000	
Realisation A/c	Dr.	1,80,000	
To Shareholders A/c			18,00,000
(Being transfer of balances to shareholders' account)			
Shareholders A/c	Dr.	18,00,000	
To Shares in AB Ltd.			18,00,000
(Being closure of shareholders a/c)			

(iii) Journal Entries in the Books of AB Ltd.

		₹	₹
Land & building A/c	Dr.	9,00,000	
Plant & machinery A/c	Dr.	5,00,000	
Investment A/c	Dr.	80,000	
Inventory	Dr.	5,20,000	
Trade receivables	Dr.	4,10,000	
Bank	Dr.	30,000	
Goodwill	Dr.	1,80,000	
To 10% Debentures			5,00,000
To Trade payables			3,20,000
To Liquidator of A Ltd.			18,00,000
(Being the purchase consideration of A Ltd. accounted for)			
Land & building A/c	Dr.	4,50,000	
Plant & machinery A/c	Dr.	3,80,000	
Inventory A/c	Dr.	3,50,000	

Trade receivables A/c	Dr.	2,60,000	
Bank A/c	Dr.	40,000	
Goodwill A/c	Dr.	1,90,000	
To Secured loan A/c			3,00,000
To Trade payables			1,70,000
To Liquidator of B Ltd.			12,00,000
(Being purchase consideration of B Ltd. accounted for)			
Liquidator of A Ltd.	Dr.	18,00,000	
To Equity share capital			11,25,000
To Securities premium			6,75,000
(Being shares issued to Liquidator of A Ltd.)			
Liquidator of B Ltd. A/c	Dr.	12,00,000	
To Equity share capital			7,50,000
To Securities premium			4,50,000
(Being shares issued to Liquidator of B Ltd.)			

(iv) **Balance Sheet of AB Ltd.**
(After amalgamation of A Ltd. & B Ltd.)

Particulars	Note No	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	18,75,000
(b) Reserves and Surplus	2	11,25,000
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	8,00,000
(3) Current Liabilities		
(a) Trade payables		4,90,000
Total		42,90,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets	4	
Tangible assets		22,30,000
Intangible assets		3,70,000
(b) Non-current investment		80,000

(2) Current assets		
(a) Inventories		8,70,000
(b) Trade receivables		6,70,000
(c) Cash and cash equivalents	5	70,000
Total		42,90,000

Notes to Accounts

			₹
1.	**Share Capital**		
	1,87,500 Equity shares of ₹ 10 each fully paid up (above shares have been issued for consideration other than cash)		18,75,000
2.	**Reserve and Surplus**		
	Securities premium		11,25,000
3.	**Long Term Borrowings**		
	Secured		
	10% Debentures	5,00,000	
	Secured loan	3,00,000	8,00,000
4.	**Fixed Assets**		
	(i) Tangible assets		
	Land & Building	13,50,000	
	Plant and Machinery	8,80,000	22,30,000
	(ii) Intangible assets		
	Goodwill (1,80,000 + 1,90,000)		3,70,000
5.	**Cash and Cash Equivalents**		
	Cash at Bank		70,000

Illustration 2

A Ltd. agreed to acquire the business of B Ltd. as on 31st December, 2011. On that date Balance Sheet of B Ltd. was summarized as follows:

Liabilities	*₹*	*Assets*	*₹*
Share Capital (Fully paid		*Goodwill*	*50,000*
shares of ₹ 10 each)	*3,00,000*	*Land, Building and Plant*	*3,20,000*
General Reserve	*85,000*	*Inventory*	*84,000*
P & L A/c	*55,000*	*Trade receivables*	*18,000*
6% Debentures	*50,000*	*Cash & Bank Balance*	*28,000*
Trade payables	*10,000*		
	5,00,000		*5,00,000*

The Debenture holders agreed to receive such 7% Debentures issued as 96 each as would discharge the debentures in B Ltd. at a premium of 20%. The shareholders in B Ltd. were to receive ₹ 2.50 in cash per share and 3 shares in A Ltd. for every two shares held – the shares in A Ltd. being considered as worth ₹ 12.50 each.

There were fractions equaling 50 shares for which each was paid. The directors of A Ltd. considered the various assets to be valued as follows:

	₹
Land	*1,00,000*
Buildings	*2,50,000*
Plant	*3,50,000*
Inventory	*80,000*
Trade receivables	*18,000*

The cost of liquidation of B Ltd. ultimately was ₹ 5,000. Due to a technical hitch, the transaction could be completed only on 1st July, 2011. Till date B Ltd. carried on trading which resulted in a profit ₹ 20,000 (subject to interest) after providing ₹ 15,000 as depreciation. On 30th June, 2011 Inventory was ₹ 90,000.Trade receivables were ₹ 25,000 and Trade payables were ₹ 15,000. There was no addition to or deletion from the fixed assets. It was agreed that the profit should belong to A Ltd.

You are required, as on July 1, 2012, to:

(i) prepare Realisation Account and the Shareholders Account in the ledger of B Ltd., and

(ii) give journal entries in the books of A Ltd.

Solution

Ledger of B Ltd.

Realisation Account

		₹			₹
To	Sundry Assets, transfer :		By	Trade payables	15,000
	Goodwill	50,000	By	6% Debentures	50,000
	Land, Building, Plant, etc.	3,20,000	By	A Ltd. - purchase consideration (2)	6,37,500
To	Inventory	90,000			
To	Trade receivable	25,000	By	Provision for Depreciation	15,000
To	Cash & Bank Balance (1)	55,000	By	A Ltd. [for profit (3)]	20,000
To	Shareholders - profit	1,97,500			
		7,37,500			7,37,500

Shareholders Account

	₹		₹
To Cash	75,625	By Share Capital A/c - transfer	3,00,000
To Shares in A Ltd.	5,61,875	By General Reserve	85,000
		By P & L A/c	55,000
		By Realisation A/c	1,97,500
	6,37,500		6,37,500

Note : It is clear that the costs of liquidation will be payable by A Ltd. since the amount payable to the shareholders has been specified.

			₹	₹
(1)	Cash and Bank Balances as on Jan. 1, 2012			28,000
	Add: Profit earned			20,000
	Depreciation provided (no cash payment)			15,000
	Increase in Trade payables			5,000
				68,000
	Less: Increase in Inventory		6,000	
	Increase inTrade receivables		7,000	(13,000)
				55,000
(2)	Purchase Consideration:			
	For Shareholders	— Cash 30,000 × ₹ 2.50		75,000
		— Shares 30,000 × 3/2 – 50 = 44,950 @ ₹ 12.5		5,61,875
		— Cash for fractions of shares 50 @ ₹ 12.50		625
				6,37,500

(3) Since the transfer of assets is as on 30th June, 2012, the profit of ₹ 20,000 must be standing to the credit of A Ltd.

Journal of A Ltd.

2011			*Dr.(₹)*	*Cr. (₹)*
July 1	Business Purchase Account	Dr.	6,37,500	
	To Liquidator of B Ltd.			6,37,500
	(Purchase consideration settled as per agreement dated... for the business of B Ltd.)			
	Land A/c	Dr.	1,00,000	
	Buildings A/c	Dr.	2,50,000	
	Plant A/c	Dr.	3,50,000	
	Inventory A/c	Dr.	86,000	
	Trade receivables A/c	Dr.	25,000	

Bank A/c	Dr.	55,000	
To Provision for Depreciation A/c			15,000
To Profit & Loss Suspense A/c			20,000
To Trade payables A/c			15,000
To Business Purchase A/c			6,37,500
To Liability for Debentures in B Ltd			60,000
To Capital Reserve A/c			1,18,500
(Various assets and liabilities taken over from B Ltd. – profit up to June 30, 2012 being credited to P & L Suspense A/c since it is to be adjusted for interest and additional depreciation due to increase in values of assets)			
Capital Reserve A/c	Dr.	5,000	
To Cash A/c			5,000
(Expenses of Liquidation paid by A Ltd.)			
Liquidator of B Ltd.	Dr.	6,37,500	
To Cash A/c			75,625
To Share Capital A/c			4,49,500
To Securities Premium A/c			1,12,375
(Discharge of the purchase consideration as per agreement)			
Liability for Debentures in B Ltd. A/c	Dr.	60,000	
Discount on issue of debentures A/c	Dr.	2,500	
To 7% Debentures A/c			62,500
(Discharge of debenture holders of B Ltd.)			

Note : (1) Debentures are issued at ₹ 96. Hence the nominal value is 60,000 × $\frac{100}{96}$ or ₹ 62,500; ₹ 2,500 is, therefore, debited to the Discount on Issue of Debentures Account.

(2) It is assumed that the reduction in the value of the Inventory as on Jan. 1, 2012 still applies.

Illustration 3

Star and Moon had been carrying on business independently. They agreed to amalgamate and form a new company Neptune Ltd. with an authorised share capital of ₹ 2,00,000 divided into 40,000 equity shares of ₹ 5 each.

On 31st December, 2012, the respective summarized Balance Sheets of Star and Moon were as follows:

	Star	Moon
	₹	₹
Fixed Assets	3,17,500	1,82,500
Current Assets	1,63,500	83,875
	4,81,000	2,66,375
Less: Current Liabilities	(2,98,500)	(90,125)
Representing Capital	1,82,500	1,76,250

Additional Information :

(a) *Revalued figures of Fixed and Current Assets were as follows:*

	Star	Moon
	₹	₹
Fixed Assets	3,55,000	1,95,000
Current Assets	1,49,750	78,875

(b) *The Trade receivables and Trade payables—include ₹ 21,675 owed by Star to Moon.*

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

(i) *30,000 equity shares of Neptune Ltd., to Star and Moon in the proportion to the profitability of their respective business based on the average net profit during the last three years which were as follows :*

	Star	Moon
2010 Profit	2,24,788	1,36,950
2011 (Loss)/Profit	(1,250)	1,71,050
2012 Profit	1,88,962	1,79,500

(ii) *15% debentures in Neptune Ltd., at par to provide an income equivalent to 8% return on capital employed in their respective business as on 31st December, 2012 after revaluation of assets.*

You are requested to:

(1) *Compute the amount of debentures and shares to be issued to Star and Moon.*

(2) *A Balance Sheet of Neptune Ltd., showing the position immediately after amalgamation.*

Solution

(1) **Computation of Amount of Debentures and Shares to be issued:**

			Star	Moon
			₹	₹
(i)	*Average Net Profit*			
	$\frac{2,24,788 - 1,250 + 1,88,962}{3}$	=	1,37,500	
	$\frac{1,36,950 + 1,71,050 + 1,79,500}{3}$	=	1,62,500	
(ii)	*Equity Shares Issued*			
	(a) Ratio of distribution			
	Star : Moon			
	1,375 : 1,625			
	(b) Number			
	Star : 13,750			
	Moon: 16,250			
	30,000			
	(c) Amount			
	13,750 shares of ₹ 5 each	=	68,750	
	16,250 shares of ₹ 5 each	=		81,250
(iii)	*Capital Employed (after revaluation of assets)*			
	Fixed Assets		3,55,000	1,95,000
	Current Assets		1,49,750	78,875
			5,04,750	2,73,875
	Less: Current Liabilities		(2,98,500)	(90,125)
			2,06,250	1,83,750
(iv)	*Debentures Issued*			
	8% Return on capital employed		16,500	14,700
	15% Debentures to be issued to provide equivalent income :			
	Star : $16,500 \times \frac{100}{15}$	=	1,10,000	
	Moon : $14,700 \times \frac{100}{15}$	=		98,000

(2) **Balance Sheet of Neptune Ltd.**

As at 31st December, 2012

Particulars	Note No	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,50,000
(b) Reserves and Surplus	2	32,000
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	2,08,000
(3) Current Liabilities		
(a) Other current liabilities		3,66,950
Total		7,56,950
II. Assets		
(1) Non-current assets		
(a) Fixed assets		5,50,000
(2) Current assets		
(a) Other current assets		2,06,950
Total		7,56,950

Notes to Accounts

			₹
1	**Share Capital**		
	Authorised		
	40,000 Equity Shares of ₹ 5 each		2,00,000
	Issued and Subscribed		
	30,000 Equity Shares of ₹ 5 each		1,50,000
	(all the above shares are allotted as fully paid-up pursuant to a contract without payments being received in cash)		
2	**Reserve and Surplus**		
	Capital Reserve		32,000
3	**Long-term borrowings**		
	Secured Loans		
	15% Debentures		2,08,000

Working Notes:

			Star ₹	Moon ₹	Total ₹
(1)		*Purchase Consideration*			
		Equity Shares Issued	68,750	81,250	1,50,000
		15% Debentures Issued	1,10,000	98,000	2,08,000
			1,78,750	1,79,250	3,58,000
(2)		*Capital Reserve*			
	(a)	Net Assets taken over			
		Fixed Assets	3,55,000	1,95,000	5,50,000
		Current Assets	1,49,750	57,200*	2,06,950
			5,04,750	2,52,200	7,56,950
		Less : Current Liabilities	(2,76,825**)	(90,125)	(3,66,950)
			2,27,925	1,62,075	3,90,000
	(b)	Purchase Consideration	1,78,750	1,79,250	3,58,000
	(c)	Capital Reserve [(a) - (b)]	49,175		
	(d)	Goodwill [(b) - (a)]		17,175	
	(e)	Capital Reserve [Final Figure(c) - (d)]			32,000

* 78, 875 - 21,675

** 2,98,500 - 21,675

Illustration 4

P and Q have been carrying on same business independently. Due to competition in the market, they decided to amalgamate and form a new company called PQ Ltd. Following is the summarized Balance Sheet of P and Q as at 31.3.2012:

Liabilities	*P ₹*	*Q ₹*	*Assets*	*P ₹*	*Q ₹*
Capital	*7,75,000*	*8,55,000*	*Plant & machinery*	*4,85,000*	*6,14,000*
Current liabilities	*6,23,500*	*5,57,600*	*Building*	*7,50,000*	*6,40,000*
			Current assets	*1,63,500*	*1,58,600*
	13,98,500	*14,12,600*		*13,98,500*	*14,12,600*

Following are the additional information:

(i) The authorised capital of the new company will be ₹ 25,00,000 divided into 1,00,000 equity shares of ₹ 25 each.

(ii) *Liabilities of P includes ₹ 50,000 due to Q for the purchases made. Q made a profit of 20% on sale to P.*

(iii) *P has goods purchased from Q, cost to him ₹ 10,000. This is included in the Current asset of P as at 31st March, 2012.*

(iv) *The assets of P and Q are to be revalued as under:*

	P ₹	Q ₹
Plant and machinery	*5,25,000*	*6,75,000*
Building	*7,75,000*	*6,48,000*

(v) *The purchase consideration is to be discharged as under:*

(a) *Issue 24,000 equity shares of ₹ 25 each fully paid up in the proportion of their profitability in the preceding 2 years.*

(b) *Profits for the preceding 2 years are given below:*

	P ₹	Q ₹
1st year	*2,62,800*	*2,75,125*
IInd year	*2,12,200*	*2,49,875*
Total	*4,75,000*	*5,25,000*

(c) *Issue 12% preference shares of ₹ 10 each fully paid up at par to provide income equivalent to 8% return on capital employed in the business as on 31.3.2012 after revaluation of assets of P and Q respectively.*

You are required to:

(i) *Compute the amount of equity and preference shares issued to P and Q.*

(ii) *Prepare the Balance Sheet of P & Q Ltd. immediately after amalgamation.*

Solution

(i) **Calculation of amount of equity shares issued to P and Q**

Profits of	P ₹	Q ₹
I year	2,62,800	2,75,125
II year	2,12,200	2,49,875
Total	4,75,000	5,25,000

No. of shares to be issued = 24,000 equity shares in the proportion of the preceding 2 years' profitability

24,000 x 475/1,000	11,400 equity shares	
24,000 x 525/1,000		12,600 equity shares

Calculation of amount of 12% Preference shares issued to P and Q

	P ₹	Q ₹
Capital employed (Refer working note 1)	8,40,000	9,24,000
8% return on capital employed	67,200	73,920
12% Preference shares to be issued $\left[67,200 \times \frac{100}{12}\right]$	₹ 5,60,000	
$\left[73,920 \times \frac{100}{12}\right]$		₹ 6,16,000

Total Purchase Consideration

	P ₹	Q ₹
Equity Shares	2,85,000	3,15,000
12% Preference shares	5,60,000	6,16,000
Total	8,45,000	9,31,000

(ii) **Balance Sheet of PQ Ltd. (after amalgamation)**

Particulars	**Note No.**	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	17,76,000
(2) Current Liabilities		
(c) Other current liabilities (W.N. 3)		11,31,100
Total		29,07,100
II. Assets		
(1) Non-current assets		
(a) Fixed assets	2	
Tangible assets		26,23,000
Intangible assets		14,000
(2) Current assets		
(a) Other current assets (W.N. 2)		2,70,100
Total		29,07,100

Notes to Accounts

			₹
1	**Share Capital**		
	Equity Share Capital		

	Authorised share capital:		
	1,00,000 Equity Share of ₹ 25 each		25,00,000
	Issued and subscribed share capital:		
	24,000 Equity Shares of ₹ 25 each	6,00,000	
	Preference Share Capital		
	1,17,600 12% Preference shares of ₹ 10 each (All of the equity and preference shares have been issued for consideration other than cash)	11,76,000	17,76,000
2	**Fixed Assets**		
	(i) Tangible assets		
	Plant and Machinery	12,00,000	
	Building	14,23,000	26,23,000
	(ii) Intangible assets		
	Goodwill (W.N.1)		14,000

Working Notes:

1. Goodwill

	P ₹	Q ₹
Plant and machinery	5,25,000	6,75,000
Building	7,75,000	6,48,000
Current assets	1,63,500	1,58,600
	14,63,500	14,81,600
Less: Current liabilities	(6,23,500)	(5,57,600)
Net assets taken (capital employed)	8,40,000	9,24,000
Less: Purchase consideration	(8,45,000)	(9,31,000)
Goodwill	5,000	7,000
Total purchased goodwill		12,000
Add: Unrealised profit of ₹ 10,000 @ 20% = ₹ 2,000 is adjusted from current assets and from goodwill (since P & L A/c is not given)		2,000
Total Goodwill		14,000

2. Current Assets

	P ₹	Q ₹
Balances before amalgamation	1,63,500	1,58,600

Less: Liabilities of P due to Q	-	(50,000)
Less: Unrealised Profit on Inventory i.e.₹ 10,000 x 20%	(2,000)	
Total	1,61,500	1,08,600
Grand Total		2,70,100

3. Current Liabilities

	P ₹	Q ₹
Balances before amalgamation	6,23,500	5,57,600
Less: Liabilities of P due to Q	(50,000)	-
Total	5,73,500	5,57,600
Grand Total		11,31,100

Illustration 5

X Ltd. and Y Ltd. were amalgamated on and from 1st April, 2012 and formed a new company Z Ltd. to takeover the business of X Ltd. and Y Ltd. The summarized Balance Sheets of X Ltd. and Y Ltd., as on 31st March, 2012 are as follows:

(₹ in Crores)

Liabilities	*X Ltd.*	*Y Ltd.*	*Assets*	*X Ltd.*	*Y Ltd.*
Share Capital:			*Land and Buildings*	*38*	*25*
Equity share of ₹ 10 each	*50*	*45*	*Plant and Machinery*	*24*	*17*
10% Preference shares of ₹ 100 each	*20*	*14*	*Investments*	*10*	*6*
Revaluation Reserve	*10*	*6*	*Inventory*	*22*	*15*
General Reserve	*12*	*8*			
Investment Allowance Reserve	*5*	*4*	*Trade Receivable*	*30*	*24*
			Cash at Bank	*16*	*13*
Profit & Loss Account	*8*	*6*			
15% Debentures of ₹ 100 each (Secured)	*4*	*5*			
Trade payable	*31*	*12*			
	140	*100*		*140*	*100*

Additional Information:

(1) Z Ltd. will issue 6 equity shares for 10 equity shares of X Ltd. and 2 equity shares for 5 equity shares of B Ltd. The shares are issued @ ₹ 30 each having a face value of ₹ 10 per share.

(2) *Preference shareholders of two companies are issued equivalent number of 15% preference shares of Z Ltd. at a price of ₹ 120 per share (face value ₹ 100).*

(3) *15% Debentureholders of X Ltd. and Y Ltd. are discharged by Z Ltd. issuing such number of its 18% Debentures of ₹ 100 each so as to maintain the same amount of interest.*

(4) *Investment allowance reserve is to be maintained for 4 more years.*

Prepare the Balance Sheet of Z Ltd. after amalgamation. The amalgamation took place in the nature of purchase.

Solution

Balance Sheet of Z Ltd. as at 1st April, 2012

(₹ in crores)

Particulars	Note No	
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	82.00
(b) Reserves and Surplus	2	116.50
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	7.50
(3) Current Liabilities		
(a) Trade payables		43
Total		249.00
II. Assets		
(1) Non-current assets		
(a) Fixed assets	4	104.00
(b) Non-current investments		16.00
(c) Other non-current assets	6	9.00
(2) Current assets		
(a) Current investments		
(b) Inventories		37.00
(c) Trade receivables		54.00
(d) Cash and cash equivalents	5	29.00
Total		249.00

Notes to Accounts *(₹ in crores)*

1	**Share Capital**		
	Equity Share Capital		
	4,80,00,000 Equity shares of ₹ 10 each	48.00	

	Preference Share Capital		
	34,00,000 15% Preference Shares of ₹ 100 each	34.00	82.00
	(all the above shares are allotted as fully paid up pursuant to contracts without payment being received in cash)		
2	**Reserve and Surplus**		
	Security Premium (60 + 36 + 4 + 2.8)	102.80	
	Capital Reserve	4.70	
	Investment Allowance Reserve	9.00	116.50
3	**Long Term Borrowings**		
	Secured Loans		
	18% of Debentures (₹ 100 each)	7.50	7.50
4	**Fixed assets**		
	Tangible assets		
	Land and Buildings	63.00	
	Plant and Machinery	41.00	104.00
5	**Cash and cash equivalents**		
	Cash At Bank		29.00
6	**Other non-current assets**		
	Amalgamation Adjustment Account		9.00

Note: Since Investment Allowance Reserve is to be maintained for 4 years, it is carried forward by a corresponding debit to Amalgamation Adjustment Account in accordance with AS-14.

Working Notes:

1.	**Calculation of Net assets taken over**		*(₹ In crores)*	
	Particulars		X Ltd.	Y Ltd.
	Assets taken over:			
	Land and Buildings		38	25
	Plant and Machinery		24	17
	Investments		10	6
	Inventory		22	15
	Trade Receivable		30	24
	Cash at Bank		16	13
		(i)	140	100
	Liabilities taken over:			
	Debentures		3.33	4.17

Trade payable		31.00	12.00
	(ii)	34.33	16.17
Net assets taken over	(i) – (ii)	105.67	83.83

2. Calculation of value of Debentures to be issued in Z Ltd.

X Ltd.

Existing Debenture interest @ 15% = ₹ 400 lakhs x 15/100 = ₹ 60 lakhs

Debentures to be issued in Z Ltd. @ 18% to maintain the same amount of interest

= ₹ 60 lakhs x 100/18 = ₹ 333.33 lakhs or ₹ 3.33 crores

Y Ltd.

Existing Debenture interest @15% = ₹ 500 lakhs x 15/100 = ₹ 75 lakhs

Debentures to be issued in Z Ltd. @ 18% to maintain the same amount of interest

= ₹ 75 x 100/18 = ₹ 416.67 lakhs or ₹ 4.17 crores

3. Computation of Purchase Consideration: *(₹ In crores)*

		X Ltd.	***Y Ltd.***
1.	Equity Shareholders		
	$\frac{₹\ 50\ \text{crores}}{₹\ 10} \times \frac{6}{10} \times ₹\ 30$	90	
	$\frac{₹\ 45\ \text{crores}}{₹\ 10} \times \frac{2}{5} \times ₹\ 30$		54
2.	Preference Shareholders		
	$\frac{₹\ 20\ \text{crores}}{₹\ 100} \times ₹\ 120$	24	
	$\frac{₹\ 14\ \text{crores}}{₹\ 100} \times ₹\ 120$		16.8
	Total Purchase consideration	114	70.8

4. Calculation of Goodwill/Capital Reserve (₹ in crores)

Particulars	*X Ltd.*	*Y Ltd.*
Net Assets takeover	105.67	83.83
Less: Purchase Consideration	(114.00)	(70.80)
Goodwill	8.33	----
Capital Reserve	---	13.03

Note: Goodwill arising from amalgamation shall be adjusted against Capital Reserve arising from amalgamation, and only balance of ₹ 4.70 crores is to be shown in the Balance Sheet of Z Ltd as capital reserve.

Illustration 6

The summarized Balance Sheet of A Limited and B Limited as at 31st March, 2012 are as follows:

Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Equity share of ₹ 10 each	*20,00,000*	*12,00,000*	*Sundry assets*	*30,00,000*	*18,00,000*
General reserve	*4,00,000*	*2,20,000*			
Trade payables	*6,00,000*	*3,80,000*			
	30,00,000	*18,00,000*		*30,00,000*	*18,00,000*

Sundry assets of B Ltd. includes long term investment of ₹ 4,00,000, the market value of which is now ₹ 4,80,000. A Ltd. absorbed B Ltd. on the basis of intrinsic value of the shares. The purchase consideration is to be discharged in fully paid-up equity shares. A sum of ₹ 1,00,000 is owed by A Ltd. to B Ltd., also included in the Inventory of A Ltd. is ₹ 1,20,000 goods supplied by B Ltd. at cost plus 20%.

Give Journal entries in the books of both the companies, if entries are made at intrinsic value. Also prepare Balance Sheet of A Ltd. after absorption.

Answer

In the Books of B Ltd.

Journal Entries

			Dr. (₹)	Cr. (₹)
(i)	Realisation A/c	Dr.	18,00,000	
	To Sundry assets A/c			18,00,000
	(Being assets transferred to realization account on sale of business to A Ltd.)			
(ii)	Trade payables A/c	Dr.	3,80,000	
	To Realisation A/c			3,80,000
	(Being trade payables transferred to realization account on sale of business to A Ltd.)			
(iii)	Equity share capital A/c	Dr.	12,00,000	
	General reserve A/c	Dr.	2,20,000	
	To Equity shareholders A/c			14,20,000
	(Being transfer of share capital and general reserve to shareholders account)			
(iv)	A Ltd.	Dr.	15,00,000	
	To Realisation A/c			15,00,000
	(Being purchase consideration due – W.N. 2)			
(v)	Equity shares in A Ltd.	Dr.	15,00,000	

	To A Ltd.			15,00,000
	(Being purchase consideration received by A Ltd.)			
(vi)	Realisation A/c	Dr.	80,000	
	To Equity shareholders A/c			80,000
	(Being profit on realization transferred to shareholders account)			
(vii)	Equity shareholders A/c	Dr.	15,00,000	
	To Equity shares in A Ltd. A/c			15,00,000
	(Being 1,25,000 shares for ₹ 12 each distributed to equity shareholders of B Ltd.)			

Journal Entries In the Books of A Ltd.

			Dr. (₹)	*Cr. (₹)*
(i)	Business purchase A/c	Dr.	15,00,000	
	To Liquidators of B Ltd. A/c			15,00,000
	(Being amount payable to B Ltd. – W.N. 2)			
(ii)	Sundry assets A/c	Dr.	18,80,000	
	To Trade payables A/c			3,80,000
	To Business purchase A/c			15,00,000
	(Being assets & liabilities taken over and purchase consideration due)			
(iii)	Liquidators of B Ltd. A/c	Dr.	15,00,000	
	To Equity share capital A/c			12,50,000
	To Securities premium A/c			2,50,000
	(Being shares allotted in full payment of purchase consideration)			
(iv)	Trade payables A/c	Dr.	1,00,000	
	To Trade receivables (of B Ltd.) A/c			1,00,000
	(Being cancellation of mutual liability of Trade receivables &Trade payables of ₹ 1,00,000)			
(v)	General reserve A/c	Dr.	20,000*	
	To Inventory A/c			20,000
	(Being elimination of unrealized profit on unsold Inventory of ₹ 1,20,000, bought from B Ltd.)			

*Unrealized profit = ₹ 1,20,000 × 20/120 = ₹ 20,000.

Balance Sheet of A Ltd.
as at 31st March, 2012

Particulars	*Note No*	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	32,50,000
(b) Reserves and Surplus	2	6,30,000
(2) Non-Current Liabilities		
(3) Current Liabilities		
(a) Trade payables	3	8,80,000
Total		47,60,000
II. Assets		
(1) Non-current assets		
Non-current investment		4,80,000
(2) Current assets	4	42,80,000
Total		47,60,000

Notes to Accounts

1	**Share Capital**		
	3,25,000 Equity shares of ₹ 10 each		32,50,000
	(of the above, 1,25,000 equity shares of ₹ 10 each are issued for consideration other than cash)		
2	**Reserve and Surplus**		
	Securities premium	2,50,000	
	General reserve	3,80,000	6,30,000
3	**Trade payables**		
	(6,00,000 + 3,80,000- 1,00,000)		8,80,000
4	**Current assets**		
	Sundry assets		
	(30,00,000 + 14,00,000 – 1,00,000 – 20,000)		42,80,000

Working Notes:

1. **Calculation of Intrinsic Value of shares of 'A' Ltd.**

	₹
Sundry assets of A Ltd.	30,00,000

Less: Trade payables	(6,00,000)
Net assets	24,00,000
Number of equity shares	2,00,000 shares
Intrinsic value per equity share = $\frac{₹\ 24,00,000}{2,00,000\ \text{shares}}$	₹ 12 per share

2. Calculation of Purchase Consideration ₹

Sundry assets of B Ltd. (other than investment)	14,00,000
Add: Investments at market value	4,80,000
	18,80,000
Less: Trade payables	(3,80,000)
Net assets	15,00,000
	Shares
Total number of equity shares to be issued by A Ltd. @₹ 12 per share (₹ 15,00,000 / ₹ 12)	1,25,000
	₹
Equity share capital (1,25,000 shares × ₹ 10)	12,50,000
Securities premium (1,25,000 shares × ₹ 2)	2,50,000
Purchase consideration	15,00,000

Illustration 7

The following are the summarized Balance Sheets of A Ltd. and B Ltd. as on 31st December, 2011:

Liabilities	*A Ltd.* ₹	*B Ltd.* ₹	*Assets*	*A Ltd.* ₹	*B Ltd.* ₹
Share Capital			*Fixed Assets*	*7,00,000*	*2,50,000*
Equity Shares of ₹ 10 each	*6,00,000*	*3,00,000*	*Current Assets: Inventory*	*2,40,000*	*3,20,000*
10% Pref. Shares of ₹100 each	*2,00,000*	*1,00,000*	*Trade Receivable*	*5,00,000*	*2,90,000*
Reserves and Surplus	*3,00,000*	*2,00,000*	*Cash at Bank*	*1,10,000*	*40,000*
Secured Loans:					
12% Debentures	*2,00,000*	*1,50,000*			
Current Liabilities:					
Trade Payable	*2,50,000*	*1,50,000*			
	15,50,000	*9,00,000*		*15,50,000*	*9,00,000*

Details of Trade receivables and trade payables are as under:

Trade payables	*A Ltd.*	*B Ltd.*
Sundry Creditors	*2,20,000*	*1,25,000*
Bills Payable	*30,000*	*25,000*
	2,50,000	*1,50,000*
Trade receivables		
Debtors	*3,60,000*	*1,90,000*
Bills Receivable	*1,40,000*	*1,00,000*
	5,00,000	*2,90,000*

Fixed Assets of both the companies are to be revalued at 15% above book value. Inventory in Trade and Debtors are taken over at 5% lesser than their book value. Both the companies are to pay 10% Equity dividend, Preference dividend having been already paid.

After the above transactions are given effect to, A Ltd. will absorb B Ltd. on the following terms:

(i) 8 Equity Shares of ₹ 10 each will be issued by A Ltd. at par against 6 shares of B Ltd.

(ii) 10% Preference Shareholders of B Ltd. will be paid at 10% discount by issue of 10% Preference Shares of ₹ 100 each at par in A Ltd.

(iii) 12% Debentureholders of B Ltd. are to be paid at 8% premium by 12% Debentures in A Ltd. issued at a discount of 10%.

(iv) ₹ 30,000 is to be paid by A Ltd. to B Ltd. for Liquidation expenses. Sundry Creditors of B Ltd. include ₹ 10,000 due to A Ltd.

Prepare:

(a) Absorption entries in the books of A Ltd.

(b) Statement of consideration payable by A Ltd.

Solution

(a) Absorption Entries in the Books of A Ltd.

		Dr. ₹	Cr. ₹
Fixed Assets	Dr.	1,05,000	
To Revaluation Reserve			1,05,000
(Revaluation of fixed assets at 15% above book value)			
Reserve and Surplus	Dr.	60,000	
To Equity Dividend			60,000
(Declaration of equity dividend @ 10%)			

Equity Dividend	Dr.	60,000	
To Bank Account			60,000
(Payment of equity dividend)			
Business Purchase Account	Dr.	5,20,000	
To Liquidator of B Ltd.			5,20,000
(Consideration payable for the business taken over from B Ltd. inclusive of liquidation expenses of ₹ 30,000)			
Fixed Assets (115% of ₹ 2,50,000)	Dr.	2,87,500	
Inventory (95% of ₹ 3,20,000)	Dr.	3,04,000	
Debtors	Dr.	1,90,000	
Bills Receivable	Dr.	1,00,000	
Cash at Bank	Dr.	10,000	
(₹ 40,000 – ₹ 30,000 dividend paid)			
To Provision for Bad Debts (5% of ₹ 1,90,000)			9,500
To Sundry Creditors			1,25,000
To 12% Debentures in B Ltd.			1,62,000
To Bills Payable			25,000
To Business Purchase Account			5,20,000
To Capital Reserve (Balancing figure)			50,000
(Incorporation of various assets and liabilities taken over from B Ltd. at agreed values, profit being credited to capital reserve)			
Liquidator of B Ltd.	Dr.	5,20,000	
To Equity Share Capital			4,00,000
To 10% Preference Share Capital			90,000
To Bank A/c			30,000
(Discharge of consideration for B Ltd.'s business and liquidation expenses of ₹ 30,000)			
12% Debentures in B Ltd. (₹ 1,50,000 × 108%)	Dr.	1,62,000	
Discount on Issue of Debentures	Dr.	18,000	
To 12% Debentures			1,80,000
(Allotment of 12% Debentures to debenture holders at a discount of 10% to discharge the liability on B Ltd. debentures)			

Sundry Creditors To Sundry Debtors (Cancellation of mutual owing)	Dr.	10,000	 10,000

(b) Statement of Consideration payable by A Ltd.

Shares to be allotted $30,000/6 \times 8 = 40,000$

i.e. A Ltd. will issue 40,000 shares of ₹ 10 each= ₹ 4,00,000 (i)

For 10% preference shares, to be paid at 10% discount

₹ $\frac{1,00,000 \times 90}{100}$ ₹ 90,000 (ii)

Consideration amount [(i) + (ii)] ₹ 4,90,000

Note: It has been assumed that dividend on equity shares have been paid by both the companies.

Illustration 8

AX Ltd. and BX Ltd. amalgamated on and from 1st January, 2013. A new Company ABX Ltd. was formed to take over the businesses of the existing companies.

Summarized Balance Sheet as on 31-12-2012

Equity and Liabilities	*AX Ltd. ₹ '000*	*BX Ltd. ₹ '000*	*Assets*	*AX Ltd. ₹ '000*	*BX Ltd. ₹ '000*
Share Capital			*Sundry Fixed*		
Equity Shares of			*Assets*	*85,00*	*75,00*
₹ 10 each	*60,00*	*70,00*	*Investment*	*10,50*	*5,50*
General Reserve	*15,00*	*20,00*	*Inventory*	*12,50*	*27,50*
P & L A/c	*10,00*	*5,00*	*Trade receivables*	*18,00*	*40,00*
Investment Allowance			*Cash & Bank*	*4,50*	*4,00*
Reserve	*5,00*	*1,00*			
Export Profit Reserve	*50*	*1,00*			
12% Debentures	*30,00*	*40,00*			
Trade payables	*10,00*	*15,00*			
	130,50	*152,00*		*130,50*	*152,00*

ABX Ltd. issued requisite number of shares to discharge the claims of the equity shareholders of the transferor companies.

You are required to prepare (i) Note showing purchase consideration and discharge thereof, *(ii) Journal entries in the books of ABX Ltd. For taking over both companies, (iii) Balance Sheet of ABX Ltd. as on 1st January, 2013 assuming the amalgamation is in the nature of purchase.*

Solution

(i) Calculation of Purchase Consideration

		AX Ltd. ₹ '000		***BX Ltd.*** ₹ '000
Assets taken over:				
Sundry fixed assets		85,00		75,00
Investments		10,50		5,50
Inventory		12,50		27,50
Trade receivables		18,00		40,00
Cash & Bank		4,50		4,00
Gross Assets		130,50		152,00
Less : Sundry Liabilities				
12% Debentures	30,00		40,00	
Trade payables	10,00	(40,00)	15,00	(55,00)
Purchase Consideration		90,50		97,00

. **Discharge of Purchase consideration:**

	AX Ltd. ₹ '000	***BX Ltd.*** ₹ '000
9,05,000 Equity Shares of ₹ 10 each	90,50	
9,70,000 Equity Shares of ₹ 10 each		97,00

(ii) Journal entries in books of ABX Ltd.

		₹'000	*₹'000*
Business Purchase A/c	Dr.	18,750	
To Liquidator of AX Ltd.			90,50
To Liquidator of BX Ltd.			97,00
(Being Business of AX Ltd. & BX Ltd. purchased)			
Sundry fixed assets	Dr.	85,00	
Investment A/c	Dr.	10,50	
Inventory	Dr.	12,50	
Trade receivables	Dr.	18,00	
Cash and Bank	Dr.	4,50	

To 12% Debentures			30,00
To Trade payables			10,00
To Business Purchase A/c			90,50
(Being the purchase consideration of AX Ltd. accounted for)			
Sundry fixed assets	Dr.	75,00	
Investment A/c	Dr.	5,50	
Inventory	Dr.	27,50	
Trade receivables	Dr.	40,00	
Cash and Bank	Dr.	4,00	
To 12% Debentures			40,00
To Trade payables			15,00
To Business Purchase A/c			97,00
(Being the purchase consideration of BX Ltd. accounted for)			
Liquidator of AX Ltd.	Dr.	90,50	
To Equity share capital A/c			90,50
(Being shares issued to Liquidator of AX Ltd.)			
Liquidator of BX Ltd. A/c	Dr.	97,00	
To Equity share capital A/c			97,00
(Being shares issued to Liquidator of BX Ltd.)			

(iii) Balance Sheet of ABX Ltd. as on 1.1.2013

Particulars	*Note No.*	*(₹ 000)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	187,50
(b) Reserves and Surplus	2	7,50
(2) **Non-Current Liabilities**		
Long-term borrowings	3	70,00
(3) **Current Liabilities**		
(a) Trade payables (10,00 + 15,00)		25,00
Total		290,00
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets (85,00 + 75,00)		160,00
(b) Non-current Investments (10,50+ 5,50)		16,00

	(c)	Other non-current asset	4	7,50
(2)	**Current assets**			
	(a)	Inventories (12,50 + 27,50)		40,00
	(b)	Trade Receivables (18,00 + 40,00)		58,00
	(c)	Cash & Cash equivalents (4,50 + 4,00)		8,50
		Total		290,00

Notes to Accounts

		(₹ 000)	(₹ 000)
1.	**Share Capital**		
	18,75,000 Equity Shares of ₹ 10 each		187,500
2.	**Reserves and surplus**		
	Investment Allowance Reserve	6,00	
	Export Profit Reserve	1,50	7,50
3.	**Long Term Borrowings**		
	12% Debentures (Assumed that new debentures were issued in exchange of the old series)		70,00
4.	**Other non-current assets**		
	Amalgmation Adjustment Account		7,50

Notes :

(1) Shares are issued by ABX Ltd. on the basis of net assets acquired of AX Ltd. and BX Ltd. Hence, there is no goodwill.

(2) The statutory reserves of AX Ltd. and BX Ltd. are shown in the balance sheet of ABX Ltd. with a corresponding debit in Amalgamation Adjustment Account.

Internal Reconstruction of a Company

Illustration 9

Following is the Summary Balance Sheet of ABC Ltd. as at 31st March, 2012:

Liabilities	*₹*	*Assets*	*₹*
Share capital:		*Plant and machinery*	*9,00,000*
2,00,000 Equity shares of		*Furniture and fixtures*	*2,50,000*
₹ 10 each fully paid up	*20,00,000*	*Patents and copyrights*	*70,000*
6,000 8% Preference shares of ₹ 100 each	*6,00,000*	*Investments (at cost) (Market value ₹ 55,000)*	*68,000*

9% Debentures	*12,00,000*	*Inventory*	*14,00,000*
Bank overdraft	*1,50,000*	*Trade receivables*	*14,39,000*
Trade payables	*5,92,000*	*Cash and bank balance*	*10,000*
		Profit and Loss A/c	*4,05,000*
	45,42,000		*45,42,000*

The following scheme of reconstruction was finalised:

(i) Preference shareholders would give up 30% of their capital in exchange for allotment of 11% Debentures to them.

(ii) Debentureholders having charge on plant and machinery would accept plant and machinery in full settlement of their dues.

(iii) Inventory equal to ₹ 5,00,000 in book value will be taken over by trade payables in full settlement of their dues.

(iv) Investment value to be reduced to market price.

(v) The company would issue 11% Debentures for ₹ 3,00,000 and augment its working capital requirement after settlement of bank overdraft.

Pass necessary Journal Entries in the books of the company. Prepare Capital Reduction account and Balance Sheet of the company after internal reconstruction.

Solution

In the Books of ABC Ltd.
Journal Entries

Particulars		₹	₹
8% Preference share capital A/c	Dr.	6,00,000	
To Preference shareholders A/c			4,20,000
To Capital reduction A/c			1,80,000
[Being 30% reduction in liability of preference share capital]			
Preference shareholders A/c	Dr.	4,20,000	
To 11% Debentures A/c			4,20,000
[Being the issue of debentures to preference shareholders]			
9% Debentures A/c	Dr.	12,00,000	
To Debenture holders A/c			12,00,000
[Being transfer of 9% debentures to debenture holders A/c]			
Debenture holders A/c	Dr.	12,00,000	
To Plant & machinery A/c			9,00,000

To Capital reduction A/c			3,00,000
[Settlement of debenture holders by allotment of plant & machinery]			
Trade payables A/c	Dr.	5,92,000	
To Inventory A/c			5,00,000
To Capital reduction A/c			92,000
[Being settlement of creditors by giving Inventorys]			
Bank A/c	Dr.	3,00,000	
To 11% Debentures A/c			3,00,000
[Being fresh issue of debentures]			
Bank overdraft A/c	Dr.	1,50,000	
To Bank A/c			1,50,000
[Being settlement of bank overdraft]			
Capital reduction A/c	Dr.	5,72,000	
To Investment A/c			13,000
To Profit and loss A/c			4,05,000
To Capital reserve A/c			1,54,000
[Being decrease in investment and profit and loss account (Dr. bal.); and balance of capital reduction account transferred to capital reserve]			

Capital Reduction Account

	₹		₹
To Investments A/c	13,000	By Preference share capital A/c	1,80,000
To Profit and loss A/c	4,05,000	By 9% Debenture holders A/c	3,00,000
To Capital reserve A/c	1,54,000	By Trade payables A/c	92,000
	5,72,000		5,72,000

Balance Sheet of ABC Ltd. (And Reduced)
As on 31st March 2012

Particulars	Note No	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	20,00,000
(b) Reserves and Surplus	2	1,54,000
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	7,20,000
Total		28,74,000

II. Assets		
(1) Non-current assets		
(a) Fixed assets	4	
Tangible assets		2,50,000
Intangible assets		70,000
(b) Non-current investments	5	55,000
(2) Current assets		
(a) Current investments		
(b) Inventories (₹ 14,00,000 – ₹ 5,00,000)		9,00,000
(c) Trade receivables		14,39,000
(d) Cash and cash equivalents		
Cash at Bank (W. N.)		1,60,000
Total		28,74,000

Notes to Accounts

			₹
1.	**Share Capital**		
	2,00,000 Equity shares of ₹ 10 each fully paid-up		20,00,000
2.	**Reserve and Surplus**		
	Capital Reserve		1,54,000
3.	**Long Term Borrowings**		
	11% Debentures (₹ 4,20,000 + ₹ 3,00,000)		7,20,000
4.	**Fixed Assets**		
	(i) Tangible assets		
	Plant & machinery	9,00,000	
	Less: Adjustment on scheme of reconstruction dated…	9,00,000	-
	Furniture & fixtures		2,50,000
	(ii) Intangible assets		
	Patents & copyrights		70,000
			3,20,000
5.	**Non Current Investments**		
	Investments (₹ 68,000 – ₹ 13,000)		55,000

Working Note:

Cash at bank = Opening balance + 11% Debentures issued – Bank overdraft paid

= ₹ 10,000 + ₹ 3,00,000 – ₹ 1,50,000 = ₹ 1,60,000

Illustration 10

S.P. Construction Co. finds itself in financial difficulty. The following is the summarized balance sheet on 31st December 2012:

Liabilities	*₹*	*Assets*	*₹*
Share capital		*Land*	*1,56,000*
20,000 Equity Shares of		*Building (net)*	*27,246*
₹ 10 each fully paid	*2,00,000*	*Equipment*	*10,754*
5% Cum. Pref. Shares of		*Goodwill*	*60,000*
₹ 10 each fully paid	*70,000*	*Investments (Quoted) in shares*	*27,000*
8% Debentures	*80,000*	*Inventory*	*1,20,247*
Loan from Directors	*16,000*	*Trade receivables*	*70,692*
Trade payables	*96,247*	*Profit & Loss Account*	*39,821*
Bank Overdrafts	*36,713*		
Interest Payable on Debentures	*12,800*		
	5,11,760		*5,11,760*

The authorised capital of the company is 20,000 Equity Shares of ₹ 10 each and 10,000 5% Cum. Preference Shares of ₹ 10 each.

During a meeting of shareholders and directors, it was decided to carry out a scheme of internal reconstruction. The following scheme has been agreed :

(1) The equity shareholders are to accept reduction of ₹ 7.50 per share. And each equity share is to be redesignated as a share of ₹ 2.50 each.

(2) The equity shareholders are to subscribe for a new share on the basis of 1 for 1 at a price of ₹ 3 per share.

(3) The existing 7,000 Preference Shares are to be exchanged for a new issue of 3,500 8% Cumulative Preference Shares of ₹ 10 each and 14,000 Equity Shares of ₹ 2.50 each.

(4) The Debenture holders are to accept 2,000 Equity Shares of ₹ 2.50 each in lieu of interest payable.

The interest rate is to be increased to 9 ½%. Further ₹ 9,000 of this 9½% Debentures are to be issued and taken up by the existing holders at ₹ 90 for ₹ 100.

(5) ₹ 6,000 of directors' loan is to be credited. The balance is to be settled by issue of 1,000 Equity Shares of ₹ 2.50 each.

(6) Goodwill and the profit and loss account balance are to be written off.

(7) The investment in shares is to be sold at current market value of ₹ 60,000.

(8) The bank overdraft is to be repaid.

(9) ₹ 46,000 is to be paid to trade payables now and balance at quarterly intervals.

(10) 10% of the trade receivables are to be written off.

(11) The remaining assets were professionally valued and should be included in the books of account as follows :

	₹
Land	*90,000*
Building	*80,000*
Equipment	*10,000*
Inventory	*50,000*

(12) It is expected that due to changed condition and new management operating profit will be earned at the rate of ₹ 50,000 p.a. after depreciation but before interest and tax.

Due to losses brought forward it is unlikely that any tax liability will arise until 2014.

You are required to show the necessary journal entries to affect the reconstruction scheme; prepare the balance sheet of the company immediately after the reconstruction.

Solution

S.P. Construction Co. Ltd.

		Dr. ₹	Cr. ₹
Equity Share Capital (₹ 10) A/c	Dr.	2,00,000	
To Capital Reduction A/c			1,50,000
To Equity Share Capital (₹ 2.50) A/c			50,000
(Equity shareholders rights of ₹ 10 shares reduced to a share of ₹ 2.50 vide Board's Resolution dated..., the amount of sacrifice credited to Capital Reduction Account)			
Bank A/c	Dr.	60,000	
To Equity Share Capital A/c			50,000
To Securities Premium A/c			10,000
(20,000 Equity shares issued for cash at premium of Re. 0.50 per share vide Board's Resolution dated...)			
5% Preference share capital A/c	Dr.	70,000	
To 8% Pref. Share Capital A/c			35,000
To Equity Share Capital A/c			35,000
(5% Preference share capital converted into 3,500 8% preference shares of ₹ 10 each and 14,000 Equity shares of ₹ 2.50 each vide Board's Resolution dated...)			
Interest Payable on Debentures A/c	Dr.	12,800	

To Equity Share Capital A/c			5,000
To Capital Reduction A/c			7,800
(2,000 Equity shares of ₹ 2.50 each issued in full and final settlement of interest payable, balance credited to Capital Reduction Account vide Board's Resolution dated.....)			
8% Debentures A/c	Dr.	80,000	
To 9 ½% Debentures A/c			80,000
(8% Debentures converted into 9 ½% Debentures vide Board's Resolution dated.....)			
Bank A/c	Dr.	8,100	
Capital Reduction A/c	Dr.	900	
To 9 ½% Debentures A/c			9,000
(₹ 9,000 Debentures issued at a discount of 10% for cash vide Board's Resolution dated.....)			
Loan from Directors A/c	Dr.	16,000	
To Capital Reduction A/c			6,000
To Equity Share Capital A/c			2,500
To Securities Premium A/c			7,500
(₹ 6,000 of directors' loan credited to Capital Reduction A/c, 1,000 Equity Shares of ₹ 2.50 each issued in settlement of the balance due. ₹ 7,500 credited to share premium A/c vide Board's Resolution dated...)			
Bank A/c	Dr.	60,000	
To Investment A/c			27,000
To Capital Reduction A/c			33,000
(Investment sold for ₹ 60,000, profit on sale credited to capital reduction A/c)			
Bank Overdraft (loan) A/c	Dr.	36,713	
Trade payables A/c	Dr.	46,000	
To Bank A/c			82,713
(Payment of Bank overdraft ₹ 36,713 and ₹ 46,000 paid to Trade payables)			
Building A/c	Dr.	52,754	
To Capital Reduction A/c			52,754
(Appreciation in the value of the building under the scheme of reconstruction dated.....)			
Capital Reduction A/c	Dr.	2,43,891	
To Goodwill			60,000

To Profit & Loss A/c		39,821
To Land		66,000
To Equipment		754
To Inventory		70,247
To Trade receivables		7,069
(Amounts written off on various assets A/c and the amount of goodwill and debit balance of profit and loss account written off under scheme of reconstruction dated...)		

Working Note :

Capital Reduction Account

	₹		₹
To Goodwill	60,000	By Equity Share Capital A/c	1,50,000
To Profit & Loss A/c	39,821	By Debenture Interest	7,800
To Trade receivables	7,069	By Loan from Directors A/c	6,000
To Land	66,000	By Investment A/c	33,000
To Equipment	754	By Building	52,754
To Inventory	70,247		
To Debentures (Discount)	900		
To Capital Reserve	4,763		
	2,49,554		2,49,554

Balance Sheet of S.P. Construction Co. Ltd. (And reduced) as on ......

Particulars	**Note No**	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,77,500
(b) Reserves and Surplus	2	22,263
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	89,000
(3) Current Liabilities		
(a) Trade payables		50,247
Total		3,39,010

II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	4	1,80,000
(b) Non-current investments	5	-
(2) Current assets		
(a) Inventories		50,000
(b) Trade receivables (₹ 7069 written off)		63,623
(c) Cash and cash equivalents	6	45,387
Total		3,39,010

Notes to Accounts

			₹
1.	**Share Capital**		
	Equity Share Capital		
	57,000 Equity shares of ₹ 2.50 each fully paid (17,000 shares issued on conversion and settlement claims against the company)		1,42,500
	Preference Share Capital		
	8% Cumulative Preference share capital		35,000
			1,77,500
2.	**Reserve and Surplus**		
	Securities Premium		17,500
	Capital Reserve		4,763
			22,263
3.	**Long-term borrowings**		
	Secured Loans		
	9½% Debentures		89,000
4.	**Fixed Assets**		
	(i) Tangible assets		
	Land	1,56,000	
	Less: written off under the scheme of reconstruction	(66,000)	90,000
	Building	27,246	
	Add: Appreciation under the scheme of reconstruction	52,754	80,000
	Equipment	10,754	

	Less: written off under the scheme of reconstruction	(754)	10,000
			1,80,000
	(ii) Intangible assets		
	Goodwill	60,000	
	Less: written off under the scheme of reconstruction	(60,000)	
5.	**Non-current investments**		
	Investments	27,000	
	Less: Sold during the year	(27,000)	
6.	**Cash and cash equivalents**		
	Cash at Bank		45,387

Illustration 11

The Summarised Balance Sheet of Revise Limited as at 31st March, 2012 was as follows :

Liabilities	*₹*	*Assets*	*₹*
Authorised and subscribed capital:		*Fixed Assets :*	
10,000 Equity shares of		*Machineries*	*1,00,000*
₹ 100 each fully paid	*10,00,000*	*Current assets :*	
Unsecured Loans :		*Inventory*	*3,20,000*
12% Debentures	*2,00,000*	*Trade receivables*	*2,70,000*
Accrued interest	*24,000*	*Bank*	*30,000*
Current liabilities		*Profit and loss account*	
Trade payables	*72,000*		
Provision for income tax	*24,000*		*6,00,000*
	13,20,000		*13,20,000*

It was decided to reconstruct the company for which necessary resolution was passed and sanctions were obtained from appropriate authorities. Accordingly, it was decided that:

(a) Each share is sub-divided into ten fully paid up equity shares of ₹ 10 each.

(b) After sub-division, each shareholder shall surrender to the company 50% of his holding, for the purpose of re-issue to debenture holders and trade payables as necessary.

(c) Out of shares surrendered, 10,000 shares of ₹ 10 each shall be converted into 12% preference shares of ₹ 10 each, fully paid up.

(d) The claims of the debenture-holders shall be reduced by 75 per cent. In consideration of the reduction, the debenture holders shall receive preference shares of ₹ 1,00,000 which are converted out of shares surrendered.

(e) Trade payables claim shall be reduced to 50 per cent, it is to be settled by the issue of equity shares of ₹ 10 each out of shares surrendered.

(f) Balance of profit and loss account to be written off.

(g) The shares surrendered and not re-issued shall be cancelled.

You are required to show the journal entries giving effect to the above and the resultant Balance Sheet.

Solution

		Dr. ₹	Cr. ₹
Equity Share Capital (₹ 100) A/c	Dr.	10,00,000	
To Share Surrender A/c			5,00,000
To Equity Share Capital (₹ 10) A/c			5,00,000
(Subdivision of 10,000 equity shares of ₹ 100 each into 1,00,000 equity shares of ₹ 10 each and surrender of 50,000 of such subdivided shares as per capital reduction scheme)			
12% Debentures A/c	Dr.	1,50,000	
Accrued Interest A/c	Dr.	18,000	
To Reconstruction A/c			1,68,000
(Transferred 75% of the claims of the debentureholders to reconstruction account in consideration of which 12% preference shares are being issued out of share surrender account as per capital reduction scheme)			
Trade payables A/c	Dr.	72,000	
To Reconstruction A/c			72,000
(Transferred claims of the trade payables to reconstruction account, 50% of which is being clear reduction and equity shares are being issued in consideration of the balance)			
Share Surrender A/c	Dr.	5,00,000	
To 12% Preference Share Capital A/c			1,00,000
To Equity Share Capital A/c			36,000
To Reconstruction A/c			3,64,000
(Issued preference and equity shares to discharge the claims of the debenture holders and the trade payables respectively as a per scheme and the balance in share surrender account is being transferred to reconstruction account)			

Reconstruction A/c	Dr.	6,04,000	
To Profit and Loss A/c			6,00,000
To Capital Reserve A/c			4,000
(Adjusted debit balance of profit and loss account against the reconstruction account and the balance in the latter is being transferred to capital reserve)			

Balance Sheet of Revise Limited (and reduced) as on...

Particulars	Note No.	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	6,36,000
(b) Reserves and Surplus	2	4,000
(2) Non-Current Liabilities		
(a) Long-term borrowings	3	50,000
(3) Current Liabilities		
(a) Other current liabilities	4	6,000
(b) Short-term provisions	5	24,000
Total		7,20,000
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
(i) Tangible assets	6	1,00,000
(2) Current assets		
(a) Current investments		
(b) Inventories		3,20,000
(c) Trade receivables		2,70,000
(d) Cash and cash equivalents		30,000
Total		7,20,000

Notes to Accounts

		₹
1.	**Share Capital**	
	Equity Share Capital	
	Issued Capital : 53,600 Equity Shares of ₹ 10 each	5,36,000
	Preference Share Capital	

	Preference Shares	1,00,000
	(Of the above shares all are allotted as fully paid up pursuant to capital reduction scheme by conversion of equity shares without payment being received in cash)	
		6,36,000
2.	**Reserve and Surplus**	
	Capital Reserve	4,000
3.	**Long-term borrowings**	
	Unsecured Loans	
	12% Debentures	50,000
4.	**Other current liabilities**	
	Accrued interest	6,000
5.	**Short-term provisions**	
	Provision for Income-tax	24,000
6.	**Tangible assets**	
	Machineries	1,00,000

Illustration 12

The shareholders of Maitri Ltd. decided on a corporate restructuring exercise necessitated because of economic recession. From the given summarised balance sheet as on 31-3-2012 and the information supplied, you are required to prepare (i) Journal entries reflecting the scheme of reconstruction, (ii) Capital reduction account, (iii) Cash account in the books of Maitri Ltd.

Summarised Balance Sheet of Maitri Ltd. as on 31.3.2012

Liabilities	*₹*	*Assets*	*₹*
Share Capital		*Fixed Assets*	
30,000 Equity shares of ₹ 10 each	*3,00,000*	*Trademarks and Patents*	*1,10,000*
40,000 8% Cumulative Preference shares ₹ 10 each	*4,00,000*	*Goodwill at cost* *Freehold Land*	*36,100* *1,20,000*
Reserves and Surplus		*Freehold Premises*	*2,44,000*
Securities Premium Account	*10,000*	*Plant and Equipment*	*3,20,000*
Profit and Loss Account *Secured Borrowings*	*(1,38,400)*	*Investment (marked to market)*	*64,000*
9% Debentures (₹100) 1,20,000		*Current Assets*	
Accrued Interest 5,400	*1,25,400*	*Inventories:*	

Current liabilities		*Raw materials and*		
Trade payables	*1,20,000*	*packing materials*	*60,000*	
Vat payable	*50,000*	*Finished goods*	*16,000*	*76,000*
Temporary bank overdraft	*2,23,100*	*Trade receivables*		*1,20,000*
	10,90,100			*10,90,100*

***Note**: Preference dividends are in arrears for 4 years.*

The scheme of reconstruction that received the permission of the Court was on the following lines:

(1) The authorized capital of the Company to be re-fixed at ₹ 10 lakhs (preference capital of ₹ 3 lakhs and equity capital of ₹ 7 lakhs). Both classes of shares are of ₹ 10 each.

(2) The preference shares are to be reduced to ₹ 5 each and equity shares reduced by ₹ 3 per share. Post reduction, both classes of shares to be re-consolidated into ₹ 10 shares.

(3) Trade Investments are to be liquidated in open market.

(4) One fresh equity shares of ₹ 10 to be issued for every ₹ 40 of preference dividends in arrears (ignore taxation).

(5) Expenses for the scheme were ₹ 10,000.

(6) The debenture holders took over freehold land at ₹ 2,10,000 and settled the balance after adjusting their dues.

(7) Unprovided contingent liabilities were settled at ₹ 54,000 and a pending insurance claim receivable settled at ₹ 12,500.

(8) The intangible assets were all to be written off along with ₹ 10,000 worth obsolete packing material and 10% of the receivables.

(9) Remaining cash available as a result of the above transactions is to be utilized to pay off the bank overdraft to that extent.

(10) The Equity shareholders agree that they will bring in necessary cash to liquidate the balance outstanding on the overdraft account by subscribing the fresh shares. The equity shares will be issued at par for this purpose.

Solution

(i) **In the books of Maitri Ltd.**

Journal Entries

	2012			Dr. ₹	Cr. ₹
1	March 31	Equity Share Capital A/c (₹ 10)	Dr.	3,00,000	
		To Capital Reduction A/c			90,000
		To Equity Share Capital A/c (₹ 7)			2,10,000
		(Being reduction of equity shares of ₹ 10 each to shares of ₹ 7 each as per Reconstruction Scheme dated...)			
2.		8% Cum. Preference Share Capital A/c (₹ 10)	Dr.	4,00,000	
		To Capital Reduction A/c			2,00,000
		To Preference Share Capital A/c (₹ 5)			2,00,000
		(Being reduction of preference shares of ₹ 10 each to shares of ₹ 5 each as per reconstruction scheme)			
3.		Equity Share Capital A/c (30,000 x ₹ 7)	Dr.	2,10,000	
		Preference Share Capital A/c (40,000 x ₹ 5)	Dr.	2,00,000	
		To Equity Share Capital A/c (21,000 x ₹ 10)			2,10,000
		To Preference Share Capital A/c (20,000 x ₹ 10)			2,00,000
		(Being post reduction, both classes of shares reconsolidated into ₹ 10 each)			
4.		Cash Account	Dr.	64,000	
		To Trade Investments			64,000
		(Being trade investments liquidated in the open market)			
5.		Capital Reduction Account	Dr.	32,000	
		To Equity Share Capital Account			32,000
		(Being arrears of preference dividends of 4 years satisfied by the issue of 3,200 equity shares of ₹ 10 each)			
6.		Capital Reduction Account	Dr.	10,000	
		To Cash Account			10,000
		(Being expenses of reconstruction scheme paid in cash)			

7.		9% Debentures Account	Dr.	1,20,000	
		Accrued Interest Account	Dr.	5,400	
		To Debenture holders Account			1,25,400
		(Being amount due to debenture holders)			
8.		Debenture holders Account	Dr.	1,25,400	
		Cash Account (2,10,000 – 1,25,400)	Dr.	84,600	
		To Freehold Land			1,20,000
		To Capital Reduction Account (2,10,000 – 1,20,000)			90,000
		(Being Debenture holders took over freehold land at ₹ 2,10,000 and settled the balance)			
9.		Capital Reduction Account	Dr.	54,000	
		To Cash Account			54,000
		(Being contingent liability of ₹ 54,000 paid)			
10.		Cash Account	Dr.	12,500	
		To Capital Reduction Account			12,500
		(Being pending insurance claim received)			
11.		Capital Reduction Account	Dr.	1,68,100	
		To Trademarks and Patents			1,10,000
		To Goodwill			36,100
		To Raw materials & Packing materials			10,000
		To Trade receivables			12,000
		(Being intangible assets written off along with raw materials and packing materials worth ₹10,000 and 10% of trade receivables)			
12.		Cash Account	Dr.	1,26,000	
		To Equity Share Capital Account			1,26,000
		(Being 12,600 shares issued to existing shareholders)			
13.		Bank Overdraft Account	Dr.	2,23,100	
		To Cash Account			2,23,100
		(Being cash balance utilized to pay off bank overdraft)			
14.		Capital Reduction Account	Dr.	1,28,400	
		To Capital reserve Account			1,28,400
		(Being balance of capital reduction account transferred to capital reserve account)			

(iii) Cash Account

Particulars	₹	Particulars	₹
To Investment	64,000	By Capital reduction (Contingent liability)	54,000
To 9% Debenture holders (2,10,000-1,25,400)	84,600	By Expenses	10,000
To Capital reduction (insurance claim)	12,500	By Temporary bank overdraft - From available cash (64,000+84,600+12,500 -54,000-10,000) 97,100	
To Equity share capital 12,600 shares @ ₹ 10 each	1,26,000	- From proceeds of equity share capital (2,23,100–97,100) 1,26,000	2,23,100
	2,87,100		2,87,100

Note: Shares issued to existing equity shareholders for bringing cash for payment of balance of bank overdraft = ₹ 2,23,100 – ₹ 97,100 = ₹ 1,26,000.

Illustration 13

The Abridged Balance Sheet (Draft) of Cyber Ltd. as on 31st March, 2012 is as under:

Liabilities	₹	Assets	₹
24,000, Equity shares of ₹ 10 each	2,40,000	Goodwill	5,000
5000, 8% cumulative preference shares of ₹ 10 each	50,000	Fixed Assets	2,57,000
		Inventories	50,000
8% Debentures	1,00,000	Trade receivables	60,000
Interest accrued on debentures	8,000	Bank	1,000
Trade payables	1,00,000	Profit & Loss Account	1,25,000
	4,98,000		4,98,000

The following scheme is passed and sanctioned by the court:

(i) A new company Mahal Ltd is formed with ₹ 3,00,000, divided into 30,000 Equity shares of ₹ 10 each.

(ii) The new company will acquire the assets and liabilities of Cyber Ltd. on the following terms:

(a) Old company's debentures are paid by similar debentures in new company and for outstanding accrued interest, shares of equal amount are issued at par.

(b) The trade payables are paid for every ₹ 100, ₹ 16 in cash and 10 shares issued at par.

(c) Preference shareholders are to get equal number of equity shares at par. For arrears of dividend amounting to ₹ 12,000, 5 shares are issued at par for each ₹ 100 in full satisfaction.

(d) Equity shareholders are issued one share at par for every three shares held.

(e) Expenses of ₹ 8,000 are to be borne by the new company.

(iii) Current Assets are to be taken at book value (except Inventory, which is to be reduced by ₹ 3,000). Goodwill is to be eliminated, balance of purchase consideration being attributed to fixed assets.

(iv) Remaining shares of the new company are issued to public at par and are fully paid.

You are required to show:

(a) In the old company's books:

(i) Realisation Account

(ii) Equity Shareholder's Account

(b) In the new company's books:

(i) Bank Account

(ii) Summarised Balance Sheet as per the requirements of Schedule-III.

Solution

(a) (i) In the books of Cyber Ltd i.e. Old company's books

Realisation Account

	₹		₹
To Goodwill	5,000	By 8% Debentures	1,00,000
To Fixed assets	2,57,000	By Interest accrued on debentures	8,000
To Inventories	50,000		
To Trade receivables	60,000	By Trade payables	1,00,000
To Bank	1,000	By P Ltd. (Purchase consideration)	1,36,000
To Preference share holders A/c (W.N.3)	6,000	By Equity shareholders (Bal. fig.)	35,000
	3,79,000		3,79,000

(ii) Equity Shareholders' Account

	₹		₹
To Profit & loss A/c	1,25,000	By Equity Share capital	2,40,000
To Equity shares in Mahal Ltd.	80,000		
To Realisation A/c	35,000		
	2,40,000		2,40,000

(b) (i) **In the books of Mahal Ltd (New company)**

Bank Account

		₹			₹
To	Business Purchase	1,000	By	Goodwill (for expenses on absorption)	8,000
To	Equity share application & allotment A/c (W.N. 4)	56,000	By	Trade Payables $\left(\frac{1,00,000}{100} \times 16\right)$	16,000
			By	Balance c/d (Bal. fig.)	33,000
		57,000			57,000

(ii) **Balance Sheet as on 31st March, 2012**

Particulars	*Note No.*	₹
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital	1	3,00,000
(2) Non-Current Liabilities		
Long-term borrowings	2	1,00,000
Total		4,00,000
II. Assets		
(1) Non-current assets		
Fixed assets		
(a) Tangible assets** (W.N.2)		2,52,000
(b) Intangible assets	3	8,000
(2) Current assets		
(a) Inventories		47,000
(b) Trade receivables		60,000
(c) Cash and cash equivalents		33,000
Total		4,00,000

Notes to Accounts

		₹	
1.	Share Capital		
	Authorised share capital		
	30,000 equity shares of ₹ 10 each	3,00,000	

** It is assumed that fixed assets given in the balance sheet of Cyber Ltd. comprises of tangible fixed assets only.

	Issued and Subscribed		
	30,000 shares of ₹ 10 each fully paid up		3,00,000
	(out of the above, 24,400 (W.N.4) shares have been issued for consideration other than cash)		
2.	Long Term Borrowings		
	Secured		
	8% Debentures		1,00,000
3.	Intangible assets		
	Goodwill		8,000

Working Notes:

1. **Calculation of Purchase consideration**

	₹
Payment to preference shareholders	
5,000 equity shares @ ₹ 10	50,000
For arrears of dividend: (₹ 12,000 x 5 shares / ₹100) @ ₹ 10	6,000
Payment to equity shareholders	
(24,000 shares x 1/3) @ ₹ 10	80,000
Total purchase consideration	1,36,000

2. **Calculation of fair value at which fixed assets have been acquired by Mahal Ltd.**

Since, the question states that "balance of purchase consideration is being attributed to fixed assets", it is implied that the amount of purchase consideration is equal to the fair value at which the net assets have been acquired.

Therefore, the difference of fair value of net assets (excluding fixed assets) and the purchase consideration is the fair value at which the fixed assets have been acquired.

		₹
Purchase consideration / Net assets		1,36,000
Add: Liabilities:		
8% Debentures		1,08,000
Trade Payables $\left(\frac{1,00,000}{100}\times 16\right)\times\left(\frac{1,00,000}{100}\times 10\times 10\right)$		1,16,000
		3,60,000
Less: Inventory ₹ (50,000- 3,000)	47,000	
Debtors	60,000	
Bank	1,000	(1,08,000)
Fair value at which fixed assets has been acquired		2,52,000

3. Preference shareholders' Account

	₹		₹
To Equity Shares in Mahal Ltd.	56,000	By Preference Share capital	50,000
		By Realisation (Bal. fig.)	6,000
	56,000		56,000

4. Calculation of number of Equity shares issued to public

	Number of shares	
Authorised equity shares		30,000
Less: Equity shares issued for		
Interest accrued on debentures	800	
Trade Payables of Cyber Ltd. $\left(\frac{1,00,000}{100} \times 10 \text{ shares}\right)$	10,000	
Preference shareholders of Cyber Ltd.	5,000	
Arrears of preference dividend $\left(\frac{12,000}{100} \times 5\right)$	600	
Equity shareholders of Cyber Ltd. $\left(\frac{24,000}{3}\right)$	8,000	(24,400)
Number of equity shares issued to public at par for cash		5,600

Illustration 14

The Balance Sheet of X Ltd. as at 31st March, 2014 was as follows:

X Limited

Balance Sheet as at 31.03.2014

	Particulars		*Amount ₹*
I	***Equity and Liabilities***		
1	*Shareholders Fund*		
	Share Capital		
	40000 equity shares of ₹ 100 each fully paid		*40,00,000*
	20000, 10% preference shares of ₹100 each fully paid		*20,00,000*
	Reserve & Surplus		

	(a) Securities Premium Account		1,50,000
	(b) Profit & Loss Account		(23,00,000)
2.	Non Current Liabilities		
	Long Term Borrowings 7% Debentures of ₹ 100 each		4,00,000
3.	Current Liabilities		
	Other Current Liabilities		
	(a) Creditors		10,00,000
	(b) Loan from Director		2,00,000
	Total Liabilities		**54,50,000**
II	**Assets**		
1	Non Current Assets		
	Fixed Assets		
	(a) Land & Building	20,00,000	
	(b) Plant & Machinery	12,00,000	32,00,000
	Intangible Assets		
	Goodwill		4,00,000
2.	Current Assets		
	(a) Debtors	12,00,000	
	(b) Stock	5,00,000	
	(c) Cash at Bank	1,50,000	18,50,000
	Total Assets		54,50,000

No Dividend on Preference Shares has been paid for last 5 Years.

The following scheme of reorganisation was duly approved by the Court:

(i) Each equity share to be reduced to ₹ 25.

(ii) Each existing Preference Share to be reduced to ₹ 75 and then exchanged for one new 13% Preference Share of ₹ 50 each and one Equity Share of ₹ 25 each.

(iii) Preference Shareholders have forgone their right for dividend for four years. One year's dividend at the old rate is however, payable to them in fully paid equity shares of ₹ 25.

(iv) The Debenture Holders be given the option to either accept 90% of their claims in cash or to convert their claims in full into new 13 % Preference Shares of ₹ 50 each issued at *par. One-fourth (in value) of the Debenture Holders accepted Preference Shares for their claims. The rest were paid in cash.*

(v) Contingent Liability of ₹ 2,00,000 is payable which has been created by wrong action of one Director. He has agreed to compensate this loss out of the loan given by the Director to the Company.

(vi) Goodwill does not have any value in the present. Decrease the value of Plant & Machinery, Stock and Debtors by ₹ 3,00,000; ₹ 1,00,000 and ₹ 2,00,000 respectively. Increase the value of Land & Building to ₹ 25,00,000.

(vii) 50,000 new Equity Shares of ₹ 25 each are to be issued at par payable in full on application. The issue was underwritten for a commission of 4%. Shares were fully taken up.

(viii) Total expenses incurred by the Company in connection with the Scheme excluding underwriting Commission amounted to ₹ 20,000.

Pass necessary Journal Entries to record the above transactions.

Solution

In the books of X Ltd.
Journal Entries

Particulars		*Amount (₹)*	*Amount (₹)*
Equity Share Capital (₹ 100) A/c	Dr.	40,00,000	
To Equity Share Capital (₹ 25) A/c			10,00,000
To Capital Reduction A/c			30,00,000
(Being Equity Shares of ₹ 100 each reduced to ₹ 25 each and balance transferred to Capital Reduction A/c)			
10% Preference Share Capital (₹ 100) A/c	Dr.	20,00,000	
To 10% Preference Share Capital (₹ 75) A/c			15,00,000
To Capital Reduction A/c			5,00,000
(Being Preference Shares of ₹ 100 each reduced to ₹ 75 each and balance transferred to Capital Reduction A/c)			
10% Preference Share Capital (₹ 75) A/c	Dr.	15,00,000	
To 13% Preference Share Capital (₹ 50) A/c			10,00,000
To Equity Share Capital A/c			5,00,000
(Being one new 13% Preference Share of ₹ 50 each and one Equity Share of ₹ 25 each issued against 10% Preference Share of ₹ 75 each)			

Capital Reduction A/c	Dr.	2,00,000	
To Preference Share Dividend Payable A/c			2,00,000
(Being arrear of Preference Share Dividend payable for one year)			
Preference Share Dividend Payable A/c	Dr.	2,00,000	
To Equity Share Capital A/c (₹ 25)			2,00,000
(Being Equity Shares of ₹ 25 each issued for arrears of Preference Share Dividend)			
7% Debenture A/c	Dr.	4,00,000	
To Debenture Holders A/c			4,00,000
(Being balance of 7% Debentures transferred to Debenture Holders A/c)			
Debenture Holders A/c	Dr.	4,00,000	
To 13% Preference Share Capital A/c			1,00,000
To Bank A/c			2,70,000
To Capital Reduction A/c			30,000
(Being 25% of Debenture Holders opted to take 13% Preference Shares at par and remaining took 90% cash payment for their claims)			
Loan from Director	Dr.	2,00,000	
To Provision for Contingent Liability A/c			2,00,000
(Being contingent liability of ₹ 2,00,000 is payable and adjusted against loan from Director A/c)			
Bank A/c	Dr.	12,50,000	
To Equity Share Application & Allotment A/c			12,50,000
(Being application money received on 50,000 Equity Shares @ ₹ 25 each)			
Equity Share Application & Allotment A/c	Dr.	12,50,000	
To Equity Share Capital A/c			12,50,000
(Being application money transferred to Capital A/c on allotment)			
Underwriting Commission A/c	Dr.	50,000	
To Bank A/c			50,000
(Being underwriting commission paid)			
Land & Building A/c	Dr.	5,00,000	
To Capital Reduction A/c			5,00,000
(Being value of land & Building appreciated)			

Expenses on Reconstruction A/c	Dr.	20,000	
To Bank A/c			20,000
(Being payment of expenses on reconstruction)			
Capital Reduction A/c	Dr.	38,30,000	
To Goodwill A/c			4,00,000
To Plant & Machinery A/c			3,00,000
To Stock A/c			1,00,000
To Debtors A/c			2,00,000
To Profit & Loss A/c			23,00,000
To Expenses on Reconstruction A/c			20,000
To Underwriting Commission A/c			50,000
To Capital Reserve A/c			4,60,000
(Being various losses written off and balance of Capital Reduction A/c transferred to Capital Reserve A/c)			

Unit – 5 : Liquidation of Companies

Learning Objectives

After studying this unit, you will be able to

- Prepare Statement of Affairs as per the format prescribed by the Act.
- Draw Deficiency account and will be able to point out the reasons for deficiency.
- Distinguish between preferential payments and over-riding preferential payments.
- Set an order of payment of all obligations.
- Prepare Liquidator's Final Statement of account.

5.1 Statement of Affairs

In the case of a winding up by Court

- a Statement of Affairs of the company in the prescribed form verified by an affidavit, and
- containing particulars stated under section 454(1) of the Companies Act, 1956[1]

has to be submitted to the Official Liquidator. The statement should be submitted by directors and one or more persons who are the manager, secretary or other chief of the company.

In the case of a voluntary winding up either by member or creditors, a Statement of Affairs is required to be submitted.

According to the provisions contained under sections 496 and 508, Liquidator in both the types of winding up are required to hold a general meeting at the end of the first year and at the end of each succeeding year. They must lay before the meeting an account of their acts and dealing together with a statement in the prescribed form and containing prescribed particulars with respect to proceedings in and the position of the liquidation.

The Companies (Court) Rules, 1959 prescribe that the Statement of Affairs should be prepared in Form 57 contained in the Rules. The liquidators also are required to submit annual reports under sections 496 and 508. Such reports are to be presented in Form 153 of the Rules. At the close of the winding up of proceedings in a voluntary liquidation, the liquidators are required to place before the final meeting of shareholders and creditors a consolidated account of the amounts received and paid out by him in Form 156 of the Rules.

The broad lines on which the Statement of Affairs is prepared are the following —

•[1] ***It may be noted that corresponding sections of the Companies Act, 2013 have not been notified till 31st May, 2015. Therefore, relevant Sections of the Companies Act, 1956 are applicable at present. This Unit has been given in line with the provisions of the Companies Act, 1956.***

(1) Include assets on which there is no fixed charge at the value they are expected to realise. Students should note to include calls in arrear but not uncalled capital.

(2) Include assets on which there is a fixed charge. The amount expected to be realised would be compared with the amount due to the creditor concerned. Any **surplus** is to be extended to the other column. A **deficit** (the amount owed to the creditor exceeding the amount realisable from the asset) is to be added to unsecured creditors.

(3) The total of assets in point (1) and any surplus from assets mentioned in point (2) is available for all the creditors (except secured creditors already covered by specifically mortgaged assets).

(4) From the total assets available, the following should be deducted one by one :-

   (*i*) Preferential creditors,

   (*ii*) Debentures having a floating charge, and

   (*iii*) Unsecured creditors.

   If a minus balance emerges, there would be deficiency as regards creditors, otherwise there would be a surplus.

(5) The amount of total paid-up capital (giving details of each class of shares) should be added and the figure emerging will be deficiency (or surplus) as regards members.

Note: Statement of affairs should accompany eight lists :

List A Full particulars of every description of property not specifically pledged and included in any other list are to be set forth in this list.

List B Assets specifically pledged and creditors fully or partly secured.

List C Preferential creditors for rates, taxes, salaries, wages and otherwise.

List D List of debenture holders secured by a floating charge.

List E Unsecured creditors.

List F List of preference shareholders.

List G List of equity shareholders.

List H Deficiency or surplus account.

5.2 Deficiency Account

The official liquidator will specify a date for period (minimum three years) beginning with the date on which information is supplied for preparation of an account to explain the deficiency or surplus. On that date either assets would exceed capital plus liabilities, that is, there would be a reserve or there would be a deficit or debit balance in the Profit and Loss Account. The Deficiency account is divided into two parts:

1. The first part starts with the deficit (on the given date) and contains every item that increases deficiency (or reduces surplus such as losses, dividends etc.).
2. The second part starts with the surplus on the given date and includes all profits.

If the total of the first exceeds that of the second, there would be a deficiency to the extent of the difference, and if the total of the second part exceeds that of the first, there would be a surplus.

5.3 Overriding Preferential Payments

The Companies (Amendment) Act, 1985 has introduced section 529A which states that certain dues are to be settled even before the payments to preferential creditors under section 530 in the case of winding up of company. Section 529A states that in the event of winding up a company workmen's dues and debts due to secured creditors, to the extent such debts rank under section 529(1)(c), shall be paid in **priority** to all other debts. The workmen's dues and debts to secured creditors shall be paid in full, unless the assets are insufficient to meet them, in which case they shall be compensated in equal proportions.

It may be noted here that workmen's dues, in relation to a company, means the aggregate of the following sums:

(*i*) all wages or salary including wages payable for time or piece work and salary earned wholly or in part by way of commission of any workman and any compensation payable to any workman under any of the provisions of the Industrial Disputes Act, 1947;

(*ii*) all accrued holiday remuneration becoming payable to any workman or in the case of his death to any other person in his right, on the termination of his employment before, or by the effect of, the winding up order;

(*iii*) all amounts due in respect of any compensation or liability for compensation under Workmen's Compensation Act, 1923 in respect of death or disablement of any workman of the company;

(*iv*) all sums due to any workman from a provident fund, a pension fund, a gratuity fund or any other fund for the welfare of the workmen maintained by the company.

5.4 Preferential Creditors

Section 530 specifies the creditors that have to be paid in priority subject to the provisions of section 529A to unsecured creditors or creditor having a floating charge. Such creditors are known as Preferential Creditors. These are the following :

(*a*) All revenues, taxes, cesses and rates, becoming due and payable by the company to the government or to the local authority within 12 months next before the commencement of the winding up.

(*b*) All wages or salaries (including wages payable for time or piece work and salary earned wholly or in part by way of commission) of any employee due for the period not exceeding 4 months within the twelve months next before commencement of winding up provided the amount payable to one claimant will not exceed ₹ 20,000.[*]

(*c*) All accrued holiday remuneration becoming payable to any employee on account of winding up.

Note: Person who advance money for the purpose of making preferential payments under (*b*) and (*c*) above will be treated as preferential creditors, provided the money is actually so used.

(*d*) Unless the company is being wound up voluntarily for the purpose of reconstruction, all contributions payable during the 12 months next under the Employees State Insurance Act, 1948, or any other law for the time being in force.

(*e*) All sums due as compensation to employees under the Workmen's Compensation Act, 1923.

(*f*) All sums due to any employee from a provident fund, pension fund, gratuity fund or any other fund, for the welfare of the employees maintained by the company.

(*g*) The expenses of any investigation held under section 235 or 237 in so far as they are payable by the company.

Example

A company went into liquidation whose creditors are ₹ 36,000. This amount of ₹ 36,000 includes ₹ 6,000 on account of wages of 15 men at ₹ 100 per month for 4 months, immediately before the date of winding up, ₹ 9,000 being the salaries of 5 employees at ₹ 300 per month for the previous 6 months, Rent for godown for the last six months amounting to ₹ 3,000; Income-tax deducted out of salaries of employees ₹ 1,000. In addition it is estimated that the company would have to pay ₹ 3,000 as compensation to an employees for injuries suffered by him, which was contingent liability not accepted by the company and not included in above said creditors figure.

Find the amount of Preferential Creditors.

Solution

Calculation of Preferential Creditors

	`
Tax deducted at source on salaries	1,000
Wages (15 men for 4 months at ₹ 100 each)	6,000

[*] As per the Companies (Amendment) Act, 1996, the words "exceed such sum as may be notified by the Central Government in the official Gazette" shall be substituted for the words "exceed one thousand rupees" in section 530(2). [Vide Notification G.S.R. 80(E) dated 17-2-1997, the sum payable to any one claimant in relation to wages and salaries shall not exceed ₹ 20,000.]

Salaries (5 men for 4 months at ₹ 300 each)	6,000
Workmen's compensation	3,000
Total	16,000

Note:

(i) Wages or Salaries payable to any employee due for the period not exceeding 4 months within the twelve months next before commencement of winding up subject to maximum 20,000 per claimant are preferential creditors.

(ii) Rent for godown is not included in preferential creditors.

Illustration 1

X Ltd. was ordered to be wound up on March 31st, 2011 on which date its summarised balance sheet was as follows:

Liabilities		*₹*	*Assets*	*₹*
Subscribed Capital :				
10,000 shares of ₹ 100 each		*10,00,000*	*Goodwill*	*1,00,000*
5% Debentures	*1,60,000*		*Building*	*3,50,000*
Interest Accrued	*4,000*	*1,64,000*	*Plant*	*5,50,000*
(Secured by floating			*Fixtures*	*23,000*
charge on all assets)			*Stock*	*38,000*
Bank Overdraft		*25,000*	*Debtors*	*25,000*
(Secured by hypothecation of stock)			*Cash*	*500*
Trade payables		*36,000*	*P & L A/c*	*1,38,500*
Total		*12,25,000*	*Total*	*12,25,000*

The amounts estimated to be realised are : Goodwill ₹ 1,000; Building ₹ 3,00,000; Plant ₹ 5,25,000; Fixtures ₹ 10,000; Stock ₹ 31,000; Debtors ₹ 20,000.

Creditors included ₹ 6,000 on account of wages of 15 men at ₹ 100 per month for 4 months immediately before the date of winding up : ₹ 9,000 being the salaries of 5 employees at ₹ 300 per month for the previous 6 months; Rent for godown for the last six months amounting to ₹ 3,000; Income-tax deducted out of salaries of employees ₹ 1,000 and Directors Fees ₹ 500.

Three years ago, the debit balance in the Profit and Loss Account was ₹ 77,925 and since that date the accounts of the company have shown the following figures:

	Year 31-3-2009 ₹	*Year 31-3-2010 ₹*	*Year 31-3-2011 ₹*
Gross Profit	*65,000*	*45,000*	*40,000*
Wages and Salaries	*40,500*	*36,000*	*34,400*

Electricity and Water Tax	*5,750*	*6,380*	*5,260*
Debentures interest	*8,000*	*8,000*	*8,000*
Bad Debts	*8,540*	*7,600*	*6,700*
Depreciation	*6,700*		
Directors' Fees	*1,000*	*1,000*	*1,000*
Miscellaneous Expenses	*10,500*	*7,265*	*7,980*
Total	*80,990*	*66,245*	*63,340*

In addition it is estimated that the company would have to pay ₹ 5,000 as compensation to an employee for injuries suffered by him which was contingent liability not accepted by the company.

Prepare the Statement of Affairs and the Deficiency account in Form 57 of Companies (Court) Rules, 1959.

Solution:

Statement of Affairs (In liquidation) of X Ltd. on 31 March, 2011

Estimated Realisable value

					₹
Assets not specifically pledged (as per list A)					
Cash					500
Debtors					20,000
Building					3,00,000
Plant					5,25,000
Fixtures					10,000
Goodwill					1,000
					8,56,500
Assets specifically pledged (as per list B)					
	(a)	(b)	(c)	(d)	
	Estimated Realisable Value	Due to secured creditors	Deficiency ranking as unsecured	Surplus carried to the last column	
	₹	₹	₹	₹	
Stock	31,000	25,000	—	6,000	
	Estimated surplus from assets specifically pledged				6,000
	Estimated total assets available for preferential creditors, Debenture holders secured by a floating charge and unsecured creditors (carried forward)				8,62,500
	Summary of Gross Assets :				
	Gross realised value of assets specifically pledged			31,000	
	Other Assets			8,56,500	
	Total			8,87,500	

Liabilities Gross Liabilities			
₹		₹	₹
25,000	Secured creditors (as per list B) to the extent which claims are estimated to be covered by assets specifically pledged		
18,000	Preferential creditors (as per list 'C' Estimated		18,000
	balance of assets available for Debenture holders secured by a floating charge and unsecured creditors)		8,44,500
1,64,000	Debenture holders secured by floating charge (as per list D)		1,64,000
	Estimated surplus as regards debenture holders*		6,80,500
	Unsecured creditors (as per list E)		
	Estimated unsecured balance of claims of creditors partly secured on specific assets brought forward (*c*)	Nil	
	Creditors on Trade Account	16,500	
27,000	Outstanding Expenses	6,500	23,000
2,34,000	Estimated surplus as regards creditors, difference between Gross Assets (D) and Gross Liabilities as per column (E)		6,57,500
	Issued and called up capital : 1000 Equity Shares of ₹ 100 each fully called up as per list (G)		10,00,000
	Estimated deficiency as regards contributories		3,42,500

Note: This must be read subject to the following :

(1) There is no unpaid capital to the called-up.

(2) The estimates are subject to cost of the winding up and to any surplus or deficiency on trading pending realisation of assets.

List H Deficiency Account

Items contributing to deficiency:

(1)	Excess of capital and liabilities over assets three years ago as shown by the balance sheet	77,925
(2)	Net dividends or bonuses declared during the period	Nil
(3)	Net Trading Losses (after charging items shown in Note below) for the same period	60,575
(4)	Losses other than trading losses written off or for	Nil

which provision has been made in the books during the same period

(5) Estimated losses now written off for which provision has been made for the purpose of preparing the statement:

Bad Debts (Debtors)	5,000	
Loss on		
Goodwill	99,000	
Buildings	50,000	
Plant	25,000	
Fixtures	13,000	
Stock	7,000	
Workmen's Compensation	5,000	2,04,000

(6) Other items contributing to deficiency:	3,42,500
Items reducing deficiency:	Nil
Deficiency as shown by the Statement of affairs	3,42,500
Notes as to net trading profits and losses :	
Provision for depreciation on fixed assets	6,700
Charged of Income-tax	Nil
Interest on Debentures	24,000
Payment to directors made by the company and required by law to be disclosed in the accounts	3,000
Balance (being other trading losses)	26,875
	60,575

Particulars of Creditors for expenses	*Unsecured*	*Preferential*
Directors Fees	500	
Income tax on salaries	—	1,000
Rent (not distrained by landlord)	3,000	—
Wages (15 men for 4 months at ₹ 100 each)	—	6,000
Salaries (5 men for 4 months at ₹ 300 each, ₹ 9,000)	3,000	6,000
Workmen's Compensation		5,000
	6,500	18,000

Creditors on trade account are ₹ 16,500 (*i.e.,* ₹ 36,000 less the total of creditors mentioned above, excluding ₹ 5,000 for workmen's compensation).

Illustration 2

From the following particulars, prepare a Statement of Affairs and the Deficiency Account for submission to the official liquidator of the Equipment Ltd., which went into liquidation on December 31, 2012:

	₹	₹
3,000 equity shares of 100 each, ₹ 80 paid-up		*2,40,000*
6% 1,000 preference shares of ₹ 100 each fully paid-up	*1,00,000*	
Less : Calls in arrear	*(5,000)*	*95,000*
5% Debentures having a floating charge on the		
assets (interest paid upto June 30, 2012)		*1,00,000*
Mortgage on Land & Buildings		*80,000*
Trade Creditors		*2,65,500*
Owing for wages		*20,000*
Secretary's salary (@ ₹ 500 p.m.) owing		*3,000*
Managing Director's salary (@ ₹ 1,500 p.m.) owing		*6,000*

Assets	*Estimated to produce*	*Book value*
	₹	₹
Land & Building	*1,30,000*	*1,20,000*
Plant	*1,30,000*	*2,00,000*
Tools	*4,000*	*20,000*
Patents	*30,000*	*50,000*
Stock	*74,000*	*87,000*
Investments in the hands of a		
Bank for an overdraft of ₹ 1,90,000	*1,70,000*	*1,80,000*
Book Debts	*60,000*	*90,000*

On 31st December, 2007 the balance sheet of the company showed a general reserve of ₹ 40,000 accompanied by a debit balance of ₹ 25,000 in the Profit & Loss Account.

In 2008 the company made a profit of ₹ 40,000 and declared a dividend of 10% on equity shares. The company suffered a total loss of ₹ 1,09,000 besides loss of stock due to fire of ₹ 40,000 during 2009, 2010 and 2011. For 2012 accounts were not made.

The cost of winding up is expected to be ₹ 15,000.

Solution

In the matter of the Companies Act, 1956 & In the matter of Equipment Ltd. (in winding up)

Statement of Affairs on 31 December, 2012, the date of winding up

Estimated realisable value

Assets					₹
Assets not specifically pledged (as per list A)					
Trade debtors					60,000
Stock in trade					74,000
Plant					1,30,000
Tools					4,000
Patents					30,000
Unpaid calls					5,000
					3,03,000
Assets specifically pledged (as per list B)					
	Estimated Realisation	*Due to Secured Creditors*	*Deficiency Ranking as Unsecured Creditors*	*Surplus carried to the last column*	
	₹	₹	₹	₹	
Investments	1,70,000	1,90,000	20,000		
Land & Building	1,30,000	80,000		50,000	
	3,00,000	2,70,000			
	Estimated surplus from assets specifically pledged				50,000
	Estimated total assets available for preferential creditors, debenture holders and unsecured creditors				3,53,000
	Summary of Gross Assets:				
	Gross realisable value of - assets specifically charged			3,00,000	
	others assets			3,03,000	
				6,03,000	
	Estimated total assets available for preferential creditors, debenture holders, bank overdraft and unsecured creditors brought forward				3,53,000

Gross Liabilities	*Liabilities*		
₹		₹	₹
2,50,000	Secured creditors (as per List B) to the extent to which claims are estimated to be covered by assets specifically pledge		
22,000	Preferential creditors as per list C		22,000
	Estimated balance of assets available for Debenture holders, Bank & unsecured creditors		3,31,000
1,02,500	Debenture holders secured by a floating charge as per list D		(1,02,500)
	Surplus as regards debenture holders		2,28,500
	Unsecured creditors as per list E		
	Estimated unsecured balance of claim of creditors partly secured on		
	specific assets	20,000	
	Trade creditors	2,65,500	
2,92,500	Outstanding expenses	7,000	2,92,500
	Estimated deficiency as regards creditors being the difference between gross liabilities and gross assets		64,000
6,67,000			
	Issued & Called up Capital:		
	3,000 Equity shares or ₹ 100 each, ₹ 80 paid	2,40,000	
	6% 1,000 preference shares of ₹ 100 each fully called	1,00,000	3,40,000
	Estimated Deficiency as regards members as per list H		4,04,000

***Note:-** For the purpose of section 530(1)(*b*) of the Companies Act, 1956, the term "employee" shall include officers and other administrative staff members but it shall not include workmen and managing director. In fact, section 530(8)(*bb*) clearly states that the expression 'employee' does not include a workman. Also section 2(26) read with the explanation to section 269 concludes that a managing director is not an ordinary employee and hence he should not be considered as an employee for the purpose of section 530. The Secretary of a Company, being an officer, is to be included within the definition of 'employee' for the purpose of section 530.

Note: (*i*) The above is subject to cost to winding up estimated at ₹ 15,000 and to any surplus in deficiency on trading realisation of assets.

(*ii*) There are 3,000 shares unpaid @ ₹ 20 per share liable to be called up.

List H - Deficiency Account

A.	***Item contributing to Deficiency:***		₹
1.	Excess of capital & liabilities over assets on 1-1-2010		Nil
2.	Net dividend & bonuses during the period Jan.-Dec. 2010		29,700
3.	Net trading losses after charging depreciation, taxation, interest on debentures, etc. during the same period (₹ 1,09,000 + ₹ 1,31,300)		2,40,300
4.	Losses other than trading losses written off or for which provision has been made in the books during the same period - stock loss.		40,000
5.	Estimated losses now written off or for which provision has been made for the purpose of preparing the statement :	₹	
	Plant	70,000	
	Tools	16,000	
	Patents	20,000	
	Stock	13,000	
	Investments	10,000	
	Debtors	30,000	1,59,000
6.	Other reducing items contributing to deficiency		NIL
			4,69,000
B.	**Items reducing Deficiency**		
7.	Excess of assets over capital and liabilities on 1st Jan. 2008		15,000
8.	Net trading profit during the period 1st Jan. 2006 to 31st Dec. 2008		40,000
9.	Profit & Incomes other than trading profit during the same period		
10.	Other items Deficiency - Profit expected on Land & Building		10,000
			65,000
	Deficiency as shown by the statement of Affairs (A) - (B)		4,69,000
			4,04,000

Working Notes :

(1) Trial Balance to ascertain the amount of loss for 2012

	Dr. ₹	*Cr.* ₹
Land & Building	1,20,000	
Plant	2,00,000	
Tools	20,000	
Patents	50,000	
Stock	87,000	
Investments	1,80,000	
Debtors	90,000	
Equity Capital		2,40,000
6% Preference share capital		95,000
5% Debentures		1,00,000
Interest Outstanding		2,500
Mortgage on Land & Building		80,000
Trade Creditors		2,65,500
Owing for Wages		20,000
Secretary's Salary		3,000
Managing Director's Salary		6,000
Bank Overdraft		1,90,000
Profit & Loss Account on 1-1-2010	1,23,700	
	8,70,700	10,02,000
Loss for the year (balancing figure)	1,31,300	-
	10,02,000	10,02,000

Reserve & Surplus Account

2007		₹	2007		₹
Dec. 31	To Profit & Loss A/c(Transfer)	25,000	Dec. 31	By Balance b/d	40,000
2008			2008		
	To Dividend Equity Preference	24,000	Dec. 31	By Profit for the year	40,000
2009		5,700	2009		
	To Profit & Loss A/c (Loss)	1,09,000	Dec. 31	By Balance c/d	1,23,700
	To Loss of Stock	40,000			
		2,03,700			2,03,700

Illustration 3

X Co. Ltd. went into voluntary liquidation on 1st April, 2011. The following balances are extracted from its books on that date :

	₹		₹
Capital		*Machinery*	*90,000*
24,000 Equity Shares of ₹ 10 each	*2,40,000*	*Leasehold properties*	*1,20,000*
Debentures (Secured by		*Stock*	*3,000*
Floating charge)	*1,50,000*	*Debtors*	*1,50,000*
Bank overdraft	*54,000*	*Investments*	*18,000*
Creditors	*60,000*	*Cash in hand*	*3,000*
		Profit and loss account	*1,20,000*
	5,04,000		*5,04,000*

The following assets are valued as under :

	₹
Machinery	*1,80,000*
Leasehold properties	*2,18,000*
Investments	*12,000*
Stock	*6,000*
Debtors	*1,40,000*

The bank overdraft is secured by deposit of title deeds of leasehold properties. There were preferential creditors amounting ₹ 3,000 which were not included in creditors ₹ 60,000.

Prepare a statement of affairs to be submitted to the meeting of members/creditors.

Solution

Statement of Affairs of X Co. Ltd. on the 1st day of April, 2011

Assets not specifically pledged :	*Estimated realisable values*
Cash in Hand	3,000
Investments	12,000
Debtors	1,40,000
Stock	6,000
Machinery	1,80,000
	3,41,000

Assets specifically pledged :

	(a)	(b)	(c)	(d)	
	Estimated Realisable Value	Due to Secured Creditors	Deficiency ranking as unsecured	Surplus carried to last column	
	₹	₹	₹	₹	
Lease hold property	2,18,000	54,000	—	1,64,000	
	Estimated surplus from assets specifically pledged				1,64,000
	Estimated total assets available for preferential creditors, debentures holders secured by floating charge, and unsecured creditors				5,05,000
	Summary of Gross assets				
	Gross realisable value of assets				
	specifically pledged			₹ 2,18,000	
	Other assets			₹ 3,41,000	
	Gross Assets			₹ 5,59,000	
₹	Gross Liabilities(to be deducted from surplus or added to deficiency as the case may be)				
	Secured creditors to the extent to which claims are estimated to be covered by assets				
54,000	Specifically pledged				
3,000	Preferential creditors				3,000
	Estimated balance of assets available for debenture holders secured by a floating charge and unsecured creditors				5,02,000
1,50,000	Debentures				1,50,000
	Estimated surplus as regard debenture holders				3,52,000
60,000	Creditors				60,000
2,67,000					2,92,000
	Estimated surplus as regards creditors [being difference between gross assets (d) and gross liabilities (e)]				
	Issued and called up capital :				
	24,000 equity shares of ₹ 10 each				2,40,000
	Estimated surplus as regard members				52,000

Illustration 4

Insol Ltd. is to be liquidated. Their summarised Balance Sheet as at 30th September, 2012 appears as under:

Liabilities:	₹
2,50,000 equity shares of ₹ 10 each	*25,00,000*
Secured debentures (on land and buildings)	*10,00,000*
Unsecured loans	*20,00,000*
Trade creditors	*35,00,000*
	90,00,000
Assets:	
Land and Building	*5,00,000*
Other fixed assets	*20,00,000*
Current assets	*45,00,000*
Profit and Loss A/c	*20,00,000*
	90,00,000
Contingent liabilities are :	
For bills discounted	*1,00,000*
For excise duty demands	*1,50,000*

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

	₹
Land & Buildings	*11,00,000*
Other fixed assets	*18,00,000*
Current assets	*35,00,000*

Taking the above into account, prepare the statement of affairs.

Solution

Statement of Affairs of Insol Ltd. (in Liquidation)
as on 30th September, 2012

	Estimated Realisable Value (₹)
Assets not specifically pledged: (As per list A)	
Other fixed assets	18,00,000

Current assets					35,00,000
					53,00,000
Assets specifically pledged (As per List B)					
	Estimated realisable value	*Due to secured creditors*	*Deficiency*	*Surplus*	
	₹	₹	₹	₹	
Land & Buildings	11,00,000	10,00,000		1,00,000	
	Estimated total assets available to unsecured creditors				54,00,000
	Summary of Gross Assets				
	Gross realisable value of assets specifically pledged			11,00,000	
	Other assets			53,00,000	
	Gross Assets			64,00,000	
Gross liabilities ₹	**Liabilities**				
	Secured Creditors (as per list B) to the extent to which claims are estimated to be covered by assets				
10,00,000	Specifically pledged				
1,50,000	Preferential creditors (as per list C)				1,50,000
					52,50,000
	Unsecured creditors(as per list E)				
20,00,000	Unsecured Loans				20,00,000
35,00,000	Trade creditors				35,00,000
1,00,000	Contingent Liability on Bills Discounted				1,00,000
67,50,000	Estimated deficiency as regards creditors (67,50,000—64,00,000)				3,50,000
	2,50,000 Equity Shares of ₹ 10 each : (as per list G)				25,00,000
	Estimated deficiency as regards members				28,50,000

5.5 Liquidator's Final Statement of Account

In case of voluntary winding up, the statement prepared by the Liquidator showing receipts and payment of cash is called "Liquidator's Statement of Account". In case of compulsory winding up, the statement is known as "Official Liquidator's Final Account". While Preparing the Statement of Account, the following points should be noted :

(*i*) Assets are included in the prescribed order of liquidity.

(*ii*) In case of assets specifically charged in favour of creditors, only the surplus from it, if any, is recognised as "Surplus from Securities".

(*iii*) Net result of trading entered on the receipts side, profits being added and losses being deducted.

(*iv*) Payments made to redeem securities and cost of execution, *i.e.* cost of collecting debts, are deducted from the total receipts.

(v) Payments are made as shown in the following order:

(*a*) Legal Charges;

(*b*) Liquidator's Remuneration;

(*c*) Liquidation Expenses;

(*d*) Debenture holders (including interest up to the date of winding up if the company is insolvent and to the date of payment if it is solvent);

(*e*) Creditors;

Preferential (in actual practice, preferential creditors are paid before debenture holders having a floating charge). Unsecured creditors, shareholders for dividends declared but not yet paid;

(*f*) Preference shareholders; and

(*g*) Equity shareholders.

(*vi*) Arrears of dividends on cumulative preference shares should be paid up to the **date of winding up.**

(*vii*) In case of partly paid shares, it should be seen whether any amount is to be **called up** on such shares.

Firstly, the equity shareholders should be called up to pay the necessary amount (not exceeding the amount of **uncalled** capital) if creditors' claims of preference shareholders cannot be satisfied with the amount. Preference shareholders would be called upon to contribute (not exceeding the amount as yet uncalled on the shares) for paying off creditors.

(*viii*) The loss suffered by each class of shareholders, *i.e.* the amount that cannot be repaid, should be **proportionate** to the nominal value of the share. The loss per shares have nominal value of ₹ 100, and one set of shareholders has paid ₹ 80 per share and other set has paid ₹ 60 per share. Suitable adjustment will have to be made in cash in such a case; the latter set must contribute ₹ 20 first or the first set must be paid ₹ 20 first.

Illustration 5

M. Ltd. resolved on 31st December 2010 that the company be wound up voluntarily. The following was the trial balance extracted from its books as on that date:

	₹	₹
Equity shares of ₹ 10 each		*2,00,000*
9% Preference shares of ₹ 10 each		*1,00,000*
Plant (less depreciation w/o ₹ 85,000)	*2,15,000*	
Stock in trade	*2,50,000*	
Trade receivables	*55,000*	
Trade payables		*75,000*
Bank balance	*74,000*	
Preliminary Expenses	*6,000*	
Profit & Loss A/c (balance on 1st January, 2010)		*30,000*
Trading loss for the year 2010	*24,000*	
Preference dividend for the year 2010	*6,000*	
Outstanding Expenses (including mortgage interest)		*25,000*
4% Mortgage loan		*2,00,000*
Total	*6,30,000*	*6,30,000*

On 1st January, 2011 the liquidator sold to M. Ltd. Plant for ₹ 2,05,000 and stock in trade for ₹ 2,00,000. The sale was completed in January, 2011 and the consideration satisfied as to ₹ 2,62,200 in cash and as to the balance in 6% Debentures of the purchasing company issued to the liquidator at a premium of 2%.

The remaining steps in the liquidation were as follows:

(1) The liquidator realised ₹ 52,000 out of the book debts and the cost of collection amounted to ₹ 2,000.

(2) The loan mortgage was discharged on 31st January, 2011 along with interest from 31st July, 2010. Creditors were discharged subject to 2% and outstanding expenses excluding mortgage interest were settled for ₹ 2,000;

(3) On 30th June 2011 six month's interest on debentures was received from M. Ltd.

(4) Liquidation expenses amounting to ₹ 3,000 and liquidator's remuneration of 3% on disbursements to members were paid on 30th June, 2011 when:

(a) The preference shareholders were paid out in cash; and

(b) The debentures on M. Ltd. and the balance of cash were distributed ratably among the equity shareholders.

Prepare the Liquidator's Statement of Account showing the distribution.

Solution

M. Ltd. (in liquidation)
Liquidator's Statement of Account from 1st January, 2011 to 30th June, 2011

		₹			₹
Balance at Bank Realisation from :		74,000	Liquidator's remuneration		7302*
Trade receivables M. Ltd. -		52,000	(3% on ₹ 2,43, 398) Liquidation		
₹ 1,40,000 6%			Expenses Loan on		3,000
Debentures	1,42,800		mortgage with		
Cash	2,62,200	4,05,000	Accrued interest**		2,04,000
6 months' interest			Creditors including		
on debentures		4,200	Outstanding Expenses		75,500
Equity shareholders		5,35,200	Return contributors :		
Less: Cost of			6% Preference share-		
Collection of Debts		(2,000)	holders ₹ 10 per share		1,00,000
			6% Debentures	1,42,800	
			Cash (03 P. approx.)		
			per share	598	1,43,398
Total		5,33,200	Total		5,33,200

Illustration 6

Prakash Processors Ltd. went into voluntary liquidation on 31st December, 2010 when their Balance Sheet read as follows:—

Liabilities	***₹***
Issued and subscribed capital :	
5,000 10% cumulative preference shares	
of ₹ 100 each, fully paid	*5,00,000*
2,500 equity shares of ₹ 100 each, ₹ 75 paid	*1,87,500*
7,500 equity shares of ₹ 100 each, ₹ 60 paid	*4,50,000*
15% Debentures secured by a floating charge	*2,50,000*

* 3/103 × 2,50,700 (i.e. ₹ 5,32,000 less payments made to all creditors)

** It is assumed that loan is secured by a floating charge.

Interest outstanding on Debentures	*37,500*
Creditors	*3,18,750*
	17,43,750
Assets	
Land and Building	*2,50,000*
Machinery and Plant	*6,25,000*
Patents	*1,00,000*
Stock	*1,37,500*
Trade receivables	*2,75,000*
Cash at Bank	*75,000*
Profit and Loss A/c	*2,81,250*
	17,43,750

Preference dividends were in arrears for 2 years and the creditors included Preferential creditors of ₹ 38,000.

The assets realised as follows :

Land and Building ₹ 3,00,000; Machinery and Plant ₹ 5,00,000; Patents ₹ 75,000; Stock ₹ 1,50,000; Trade receivables ₹ 2,00,000.

The expenses of liquidation amounted to ₹ 27,250. The liquidator is entitled to a commission of 3% on assets realised except cash. Assuming the final payments including those on debentures is made on 30th June, 2011 show the liquidator's Statement of Account.

Solution

Prakash Processors Limited
Liquidator's Statement of Account

	Receipts		₹		Payments		₹
To	Assets realised -			By	Liquidation expenses		27,250
	Bank		75,000	By	Liquidator's Remuneration		36,750
	Other assets:			By	Debenture holders:		
	Land etc.	3,00,000			Debentures	2,50,000	
	Machinery etc.	5,00,000			Interest accrued	37,500	
	Patents	75,000			Interest 1-1-11/30-6-11	18,750	3,06,250
	Stock	1,50,000					
	Trade receivables	2,00,000	12,25,000	By	Preferential creditors		38,000
To	Call on equity shareholders (7,500 × ₹ 2.65) (1)		19,875	By	Unsecured creditors		2,80,750
				By	Preferential shareholders :		
					Preference capital	5,00,000	

				Arrear of Dividend	1,00,000	6,00,000
						12,89,000
			By	Equity shareholders -		
				₹ 12.35 on 2,500 shares		30,875
		13,19,875				13,19,875

Working Notes:

(1) Liquidator's remuneration 12,25,000 × 3/100 =₹ 36,750

(2) As the company is solvent, interest on the debentures will have to be paid for the period 1-1-2011 to 30-6-2011

$$2,50,000 \times \frac{15}{100} \times \frac{1}{2} = ₹\ 18,750$$

(3)	Total equity capital - paid up	₹ 6,37,500
	Less : Balance available after payment to unsecured and preference shares (13,00,000 — 12,89,000)	₹ (11,000)
	Loss to be born by 10,000 equity shares	₹ 6,26,500
	Loss per share	₹ 62.65
	Hence, amount of call on ₹ 60 paid share	₹ 2.65
	Refund to share on ₹ 75 paid	₹ 12.35

Illustration 7

The following is the Balance Sheet of Confidence Builders Ltd., as at 30th Sept. 2012:

Liabilities		₹	*Asset*	₹
Share Capital			*Land and Buildings*	*1,20,000*
Issued : 11% Pref. Shares			*Sundry Current Assets*	*3,95,000*
of ₹ 10 each		*1,00,000*	*Profit and Loss Account*	*38,500*
10,000 equity shares of			*Debenture Issue*	
₹ 10 each, fully paid up		*1,00,000*	*expenses not written off*	*2,000*
5,000 equity shares of				
₹ 10 each, ₹ 7.50 per				
share paid up		*37,500*		
13% Debentures		*1,50,000*		
Mortgage Loan		*80,000*		
Bank Overdraft		*30,000*		
Creditors for Trade		*32,000*		

Income-tax arrears :				
(assessment concluded				
in July 2012)				
Assessment year 2010-2011	*21,000*			
Assessment year 2011-2012	*5,000*	*26,000*		
		5,55,500		*5,55,500*

Mortgage loan was secured against land and buildings. Debentures were secured by a floating charge on all the other assets. The company was unable to meet the payments and therefore the debenture holders appointed a Receiver for the Debenture holders brought the land and buildings to auction and realised ₹ 1,50,000. He also took charge of Sundry assets of value of ₹ 2,40,000 and realised ₹ 2,00,000. The Bank Overdraft was secured by a personal guarantee of two of the Directors of the Company and on the Bank raising a demand, the Directors paid off the due from their personal resources. Costs incurred by the Receiver were ₹ 2,000 and by the Liquidator ₹ 2,800. The Receiver was not entitled to any remuneration but the liquidator was to receive 3% fee on the value of assets realised by him. Preference shareholders had not been paid dividend for period after 30th September 2010 and interest for the last half year was due to the debenture holders. Rest of the assets were realised at ₹ 1,00,000.

Prepare the accounts to be submitted by the Receiver and Liquidator.

Solution

Receiver's Receipts and Payments Account

		₹			₹
Sundry Assets realised		2,00,000	Costs of the Receiver		2,000
Surplus received from			Preferential payments		
mortgage			Creditors paid Taxes	-	
Sale Proceeds of land and building	1,50,000		raised within 12 months		26,000
Less: Applied to discharge			Debentures holders Principal	1,50,000	
of mortgage loan	(80,000)	70,000	Interest for half year	9,750	1,59,750
			Surplus transferred		
			to the Liquidator		82,250
		2,70,000			2,70,000

Liquidator's Final Statement of Account

	₹			₹
Surplus received from		Cost of Liquidation		2,800
Receiver	82,250	Remuneration to Liquidator		3,000
Assets Realised	1,00,000	Unsecured Creditors :		
Calls on Contributories :		for Trade	32,000	
On holder of 5,000		Directors for payment		
at the rate of		of Bank O/D		
₹ 2.17 per share	10,850		30,000	62,000
		Preferential Shareholders:		
		Principal	1,00,000	
		Arrears of		
		Dividends	22,000	1,22,000
		Equity shareholder :		
		Return of money to		
		contributors to holders		
		of 10,000 shares at 33		
		paise each		3,300
	1,93,100			1,93,100

Working Note :

Call from party paid shares		
Deficit before call from Equity Shares (1,82,250 — 1,89,800)	=	7,550
Notional call on 5,000 shares @ ₹ 2.50 each		12,500
Net balance after notional call		(a) 4,950
No. of shares deemed fully paid		(b) 15,000
Refund on fully paid shares $\frac{4,950}{15,000}$	=	33p
Calls on party paid share (2.50 — 0.33)	=	₹ 2.17

5.6 B List Contributories

The shareholders who transferred partly paid shares (otherwise than by operation of law or by death) within one year, prior to the date of winding up may be called upon to pay an amount (not exceeding the amount not **called** up when the shares were transferred) to pay off such creditors as existed on the date of transfer of shares and cannot be paid out of the funds otherwise available with the liquidator, provided that the existing shareholders have also failed to pay the amount due on the shares.

Illustration 8

In a liquidation which commenced on April 2, 2011 certain creditors could not receive payments out of the realisation of assets and out of the contributions from "A" list contributories. The following are the details of certain transfers, which took place in 2010 and 2011.

Shareholders	*Number of shares transferred at the date of ceasing to be member*	*Date of ceasing to be member*	*Creditors remaining unpaid and outstanding*
X	*1,500*	*1st March 2010*	*4,000*
A	*1,000*	*1st May 2010*	*6,000*
B	*1,500*	*1st July 2010*	*7,500*
C	*300*	*1st Nov. 2010*	*8,000*
D	*200*	*1st Feb. 2011*	*9,500*

All the shares were ₹ 10 each, ₹ 6 paid up ignoring expenses of and remuneration to liquidators, etc., show the amount to be realised from the various persons listed above.

Solution

X will not be liable since he transferred his shares prior to one year preceding the date of winding up. The amount of ₹ 6,000 outstanding on 1st May 2010 will have to be contributed by A, B, C & D in the ratio of number of shares held by them, *i.e.* in the ratio of 10:15:3:2; thus A will have to contribute ₹ 2,000: B ₹ 3,000, C ₹ 600 and D ₹ 400. Similarly, the further debts incurred between 1st May, 2010 and 1st July 2010, viz. ₹ 1,500 for which A is not liable will be contributed by B, C and D in the ratio of 15:3:2 B will have to contribute ₹ 1,125. C will have to contribute ₹ 255 and D will contribute ₹ 150. The further increase from ₹ 7,500 to ₹ 8,000, viz. ₹ 500 occurring between 1st July and 1st Nov. will be shared by C and D who will be liable for ₹ 300 and ₹ 200 respectively. The increase between 1st Nov. and 1st Feb., is solely the responsibility of D. Against D's liability of ₹ 2,250, he can be called upon to pay ₹ 800, the loss of ₹ 1,450 will have to be suffered by these creditors.

The following statement makes the position clear:

Statement of Liabilities of B list contributors

Creditors Outstanding on the date of ceasing to be member	*A 1,000 Shares ₹*	*B 1,500 Shares ₹*	*C 300 Shares ₹*	*D 200 Shares ₹*	*Amount to be paid to the Creditors ₹*
(1) 6,000	2,000	3,000	600	400	6,000

(2) 1,500	-	1,125	225	150	1,500
(3) 500	-	-	300	200	500
(4) 1,500	-	-	-	1,500	50*
Total (a)	2,000	4,125	1,125	2,250	8,050
(b) maximum liability on shares held	4,000	6,000	1,200	800	
(c) Amount paid (a) or (b) whichever is lower	2,000	4,125	1,125	800	

Summary

- In case of winding up of the company, a statement called Statement of affairs is prepared.
- Deficiency Account is the result of capital plus liabilities exceeding the assets or deficit or debit balance in the profit and loss account.
- Overriding preferential payments are the payments to be made for the workman's dues and debts secured to secured creditors to the extent they rank under section 529(1)(c).
- Preferential creditors have to be paid in priority to unsecured creditors or creditor having a floating charge.
- In case of voluntary winding up, the statement prepared by the Liquidator showing receipts and payment of cash is called "Liquidator's Statement of Account".
- The shareholders who transferred partly paid shares within one year, prior to the date of winding up may be called upon to pay an amount (not exceeding the amount not called up when the shares were transferred) to pay off such creditors as existed on the date of transfer of shares.

5

Financial Statements of Insurance Companies

Unit-1 : Introduction to Insurance Business

Learning Objectives

After studying this unit, you will be able to:

- Understand the basic concepts of Insurance.
- Learn the meaning of some important terms used in insurance business, namely premium, considerations for annuities granted, claims, surrender value, bonus, paid-up policy, re-insurance and agents' balances.
- Learn two main types of insurance business i.e. life insurance and general insurance and will be able to distinguish between them.
- Understand the meaning and various types of fire, marine and miscellaneous policies.
- Provisions 11 of the Insurance Act, 1938 requiring preparation of financial statements for the insurance business and Section 14 of the Act requiring maintenance of register or record of policies.

1.1 Introduction

Insurance is a contract. Here one party the Insurance Company called "Insurer" undertakes to indemnify specified losses suffered by the other party called "Insured" for a special consideration called "Premium". The term of the Insurance contract is called "Insurance Policy".

Some Important terms used in Insurance Business:-

1. Insurance Policy: It is the document issued by the insurance company containing terms of the insurance contract. It specifies the losses that are covered by the Policies and also the maximum amount that can be paid out in the event of a loss/death. This is called Policy Amount.

2. Premium: The payment made by the insured to the Insurance Company in consideration of the contract of Insurance. The premium is generally paid annually. In some cases it may be paid at shorter intervals. A point to be noted is the premium amount has to be paid “front end” i.e. before the commencement of the insurance cover/policy.

3. Claims: A claim occurs when a policy fall due for payment. In Life Insurance it arises on death or on maturity of policy. In case of General Insurance, the claim arises only when the loss occurs. while calculating the claim outstanding at the end, the claim intimated as well as the claim intimated and accepted both are considered. The adjustment entry required for this will be as follows:

Claims account Dr.

To Claims intimated and accepted but not paid account

To Claims intimated but not accepted and paid account

At the commencement of the next period a reverse entry is passed, so that when these claims intimated are paid, they may not influence the claims account of next year. However, if company rejects any claim, such amount should be transferred to the insurance fund account and not to the claims account.

Illustration 1

From the following, you are required to calculate the loss on account of claim to be shown in the revenue account for the year ending 31st December, 2011:

Claim intimated in the year	*Claim admitted in the year*	*Claim paid in the year*	*₹*
2010	*2010*	*2011*	*15,000*
2011	*2011*	*2012*	*10,000*
2009	*2010*	*2010*	*5,000*
2009	*2010*	*2011*	*12,000*
2011	*2012*	*2012*	*8,000*
2011	*2011*	*2011*	*1,02,000*

Claim on account of Re-insurance was ₹ 25,000.

Solution

	₹
Total claim paid in 2011 : ₹ (1,02,000 + 12,000 + 15,000)	1,29,000
Less: Outstanding in the beginning, *i.e.,* intimated in 2010 or earlier whether accepted in 2010 accepted in 2011(₹ 15,000+ ₹ 12,000)	(27,000)
	1,02,000
Add: Outstanding at the end, i.e., intimated in 2011 whether accepted in 2011 or in 2012 ₹ (10,000 + 8,000)	18,000
	1,20,000
Less: Re-insurance claim	(25,000)
Claims to be shown in revenue account	95,000

4. Surrender Value: When the policy holder wishes to realise the amount of policy before the expiry of the full period of the policy, he surrenders his right under the policy and is paid an amount calculated by a fixed formula. "Surrender Value" applies only to Life Insurance policies and comes into play only after two annual premiums have been paid.

5. Commission: Generally, Insurance Companies get business through agents; these agents receive commission on the basis of the amount of premium they generate for the Insurance Company. Commission paid to Agents is shown as a debit (expense) in the Revenue Accounts.

Bonus (applicable only to Life Insurance): A life insurance policy may be "with profit" or "without profits". The holder of a "without profits" policy is entitled to receive on maturity only the amount specified in the policy; but on a "with profits" policy he is entitled to receive in addition, the amount of bonuses declared on each valuation. On each valuation, the amount standing to the credit of Life Fund which is in excess over net liability, as determined by the actuary, is distributed among the shareholders and the policyholders. The share of the policyholders is paid to them as bonus, either in cash on declaration or by reduction of future premiums, or on maturity of the policy. Until the bonus is paid, it does not figure in the Revenue Account and is not payable in cash immediately but is to be payable at the time of the claim; it is described as Reversionary Bonus. The amount of Reversionary Bonus is included in claims.

Interim Bonus: It is a bonus paid to a policyholder for a period for which valuation is not complete and, therefore, the exact profit or bonus has not been determined. Such a bonus is also included in claims.

7. Reinsurance: If Insurance Company does not wish to bear the whole of risk of a policy, then it will reinsure a part of risk with some other insurer. In such a case the insurer is said to have ceded a part of its business to other insurer .i.e. the risk of the insurance is being underwritten by another Insurance Company.

In other words, in Re Insurance business transaction is defined as an agreement between the Ceding Company and the Reinsurer, where the former agrees to cede (give) and the later agrees to accept certain specified share of risk in return for a share of the premium. In such a case, on a claim arising, the claim will be shared between the two companies in the proportion they had agreed to underwrite the risk.

8. Ceding Company: An insurance company that shifts part or all of a risk it has assumed to another insurance company. The Ceding company shares the premium amount it has received to cover the risk, with the second insurance company called the Reinsurer. In return the Reinsurer company pays commission to the Ceding company for getting the business.

9. Commission on re-insurance ceded /accepted: Insurance companies get business through its agents. Such agents receive commission on the basis of the amount of business they generate for the company. When company gets re-insurance business it has to pay commission to the Ceding company also. This commission paid by the reinsurance company is called 'commission on re-insurance accepted' and is shown as an expense in the revenue account of the re insurance company.

For the ceding company, when it passes on a part of the business to the reinsurance company then the Ceding company gets its commission from the re insurance company. This commission is called 'commission on re-insurance ceded'. It is a gain to the company surrendering the business. It appears on the credit side of revenue account.

Other Terms Used in Insurance Business

1. Paid Up Policy (Applicable only to Life Insurance): If an insured is unable to continue to paying premiums on his life policy, he may discontinue the payment and convert the policy into a "Paid-up" policy. The insured amount in that case will be reduced to a figure ascertained according to the following formula:

$$\text{Paid-up value} = \frac{\text{No. of premium paid} \times \text{Sum assured}}{\text{Total No. of premium payable}}$$

Other conditions of the policy, however, will remain unchanged.

2. Annuity: It is a contract that provides an income for a specific period of time to say for a number of years or for life. The person receiving the payment is called an annuitant. Annuity payments are usually made monthly but can be quarterly, semi-annually, or annually.

3. Catastrophic Loss: A loss (or related losses) which is unbearable i.e. it causes severe consequences such as bankruptcy to a family, organization, or insurer.

4. Bonus in Reduction of Premium: In all the cases of general insurance the policy is always taken for one year and it is to be renewed after the expiry of the policy. Whether the policy is renewed with the same company, or a fresh policy is taken with some other company, it is a standing practice that the company usually grants a reduction in premium at the prescribed rate if the insured has not made any claim. This rate of reduction increases every year for usually three years if the insured does not make any claim continuously year after year.

For example, the General Insurance Companies in India allow the following rates of reduction for a motor cycle: 1st year 15%; 2nd year 25%; 3rd year 30%. This reduction is called bonus in reduction of premium.

In fact this transaction should be divided into two parts-first, the total premium (without any reduction) should be assumed to be received and then reduction granted should be assumed to be paid separately.

Thus, total premium (without reduction) should be treated as income and bonus which is subtracted should be treated as an expense. Thus-

- *If net premium received is ₹ 12,600*
- *Bonus in reduction of premium is ₹ 1,400*
- *The revenue account on the credit side will show ₹ 14,000 (₹ 12,600 + ₹ 1,400) as income and on the debit side ₹ 1,400 as an expense.*
- *The journal entry is :*

Bonus in reduction of premium account Dr.

To Premium account

1.1.1 Principles of Insurance

There are several principles governing insurance business, the important of which are discussed below.

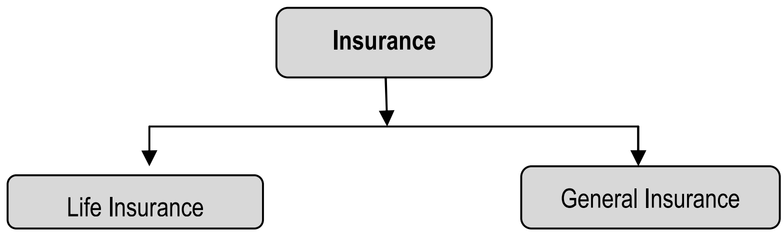
(a) Principle of indemnity: Insurance is a contract of indemnity. The insurer is called indemnifier and the insured is the indemnified. In a contract of indemnity, only those who suffer loss are compensated to the extent of actual loss suffered by them. One cannot make profit by insuring his risks.

(b) Insurable interest: All and sundry cannot enter into contracts of insurance. For example, *A* cannot insure the life of B who is a total stranger. But if *B*. happens to be his wife or his debtor or business manager, *A* has **insurable interest** i.e vested interest and therefore he can insure the life of B. For every type of policy insurable interest is insisted upon. In the absence of such interest the contract will amount to a wagering contract.

(c) Principle of *uberrimae fidei:* Under ordinary law of contract there is no positive duty to tell the whole truth in relation to the subject-matter of the contract. There is only the negative obligation to tell nothing but the truth. In a contract of insurance, however there is an implied condition that each party must disclose every material fact known to him. This is because all contracts of insurance are contracts *of uberrima fidei, i.e.,* contracts of utmost good faith. This is because the assessment of the risk and the determination of the premium by the insurer depend on the full and frank disclosure of all material facts in the proposal form.

1.2 Various Types of Insurance

Basically insurance is divided into two broad types viz;



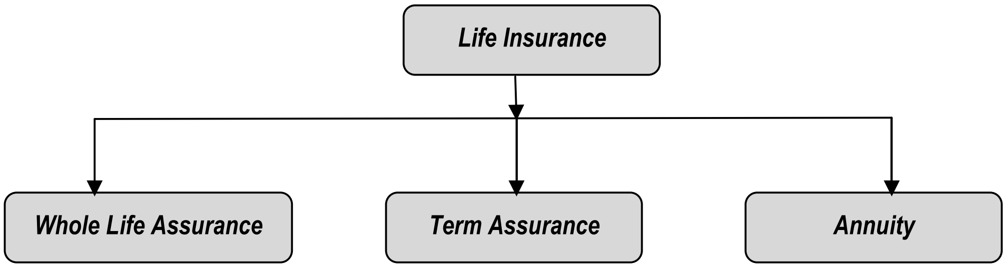
1.2.1 Life insurance policy

It covers the "life-risk" of the insured person. In case of death, the nominee will get the Insurance Policy amount. In life insurance the amount is payable on the happening of an event which is bound to occur i.e. death. So this form of Insurance is also described as "Assurance".

However, the life insurance policy also provides for payment of the policy value at maturity or by instalments and an agreed bonus. ***This payment may either be in lumpsum on maturity of the policy or may be paid in instalments called annuity.***

The uses of the terms "insurance" and "assurance" are sometimes confused. “Insurance" refers to providing cover for an event that might happen (fire, theft, flood, etc.), while "Assurance" is the provision of cover for an event that is certain to happen like death and so Life insurance is actually Life Assurance

Life Insurance can be further classified into 3 types:



Whole Life Assurance: In whole life assurance, policy amount is paid only on the death of Insured.

Term Assurance: Here the policy amount is paid in “lump-sum” on maturity of the term of the Life Insurance Policy (say 20 years).

Annuity: On maturity of the policy, instead of a one shot “lump-sum” payment the policy amount is disbursed in instalments, generally monthly.

1.2.2 General insurance

It means insurance other than life insurance

Section 2(6B) of the Insurance Act defines ‘General Insurance Business’ as fire, marine or miscellaneous insurance business whether carried on singly or in combination with one or more of them.

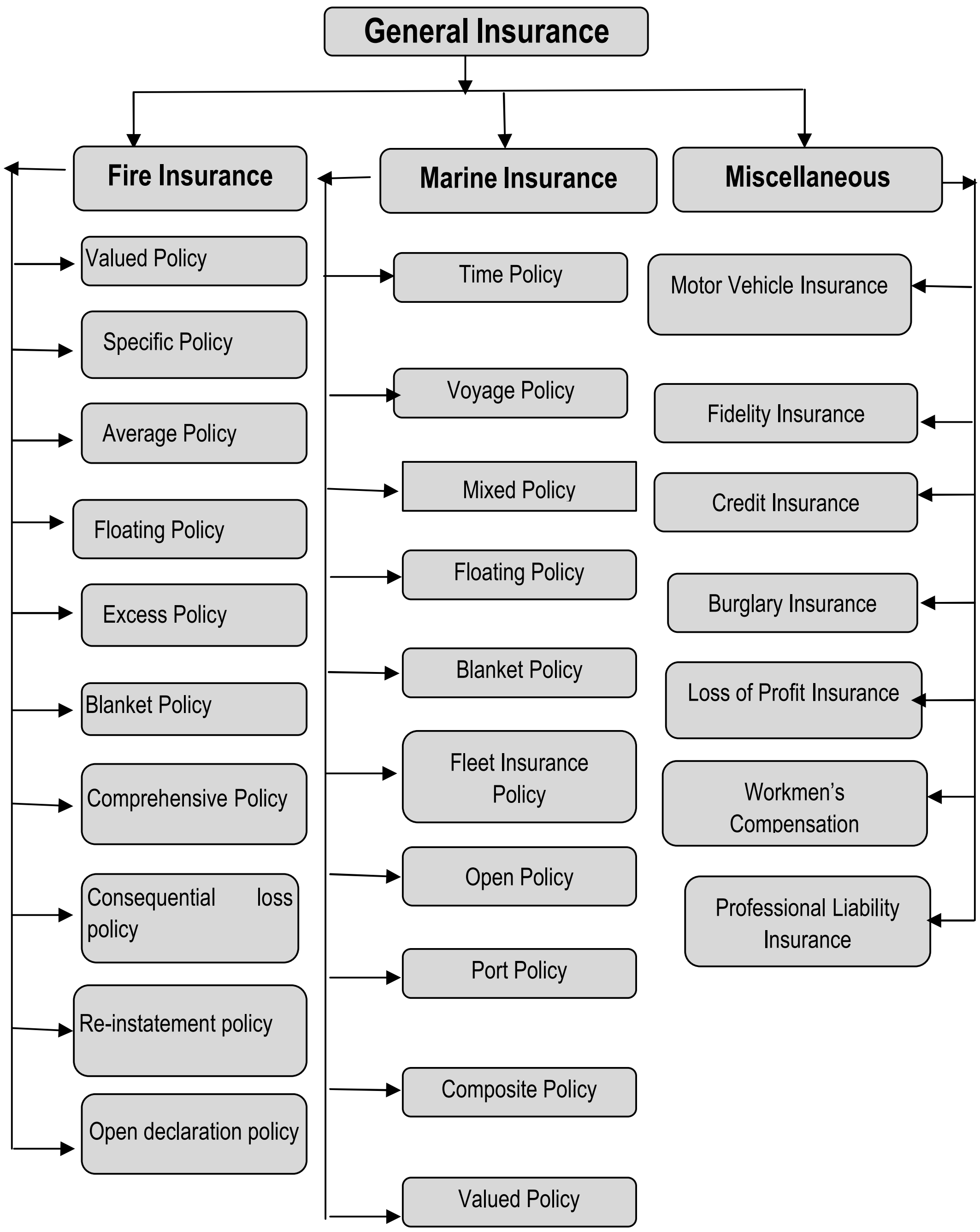
*Some common types of **miscellaneous insurance** in India are*: exchange risk insurance, motor vehicle insurance, credit insurance, burglary insurance, workmen’s compensation insurance, professional liability insurance, cash in transit insurance, fidelity insurance, etc.

1.3 Various types of General Insurance

General Insurance is broadly classified into three major categories:

1. Fire Insurance
2. Marine Insurance
3. Miscellaneous Insurance

In general insurance, the policy is taken for one year at a time and can be renewed yearly or a fresh policy can be taken with some other insurance company.


General Insurance
Fire Insurance
Marine Insurance
Miscellaneous
Valued Policy
Specific Policy
Average Policy
Floating Policy
Excess Policy
Blanket Policy
Comprehensive Policy
Consequential loss policy
Re-instatement policy
Open declaration policy
Time Policy
Voyage Policy
Mixed Policy
Floating Policy
Blanket Policy
Fleet Insurance Policy
Open Policy
Port Policy
Composite Policy
Valued Policy
Motor Vehicle Insurance
Fidelity Insurance
Credit Insurance
Burglary Insurance
Loss of Profit Insurance
Workmen's Compensation
Professional Liability Insurance

The three types of General Insurance:

1.3.1 Fire Insurance

A fire insurance contract may be defined as an **agreement whereby one party, for a consideration, undertakes to indemnify the other party upto an agreed amount against financial loss of goods or property which the latter may suffer because of fire**. Fire insurance thus covers the risk of loss of property by accidental and non-intentional fire.

Types of Fire Policies

(i) ***Valued policy* -** A policy in which the value of the property is ascertained and/or agreed upon which the insurer undertakes to pay in the event of destruction of goods/property by fire is known as *valued policy.* This type of policy is not very common these days.

(ii) ***Specific policy* -** It is a policy which insures a risk for a specific amount. In case of any loss under this policy, the insurer pays whole loss provided it is not more than the sum specified in the policy. Thus, the value of the goods/property is not considered for this purpose.

(iii) ***Average policy* -** An average policy contains the 'average clause' which lays down that if the property is under-insured, *i.e.* insured for a sum smaller than the value of the property, the insurer will bear only that proportion of the actual loss which the sum assured bears to the actual value of the property at the time of loss.

(iv) ***Floating policy* -** It is the policy which covers several types of goods lying at different locations under one amount and for one premium. The premium normally charged under this policy is the average of the premia that would have been paid if each lot of the goods had been insured under specific policies for specific sums.

(v) ***Excess policy* -** Where the stocks of the insured fluctuate he may take out a policy for the amount below which his stocks normally do not fall and another policy to cover the maximum amount of stocks which may be reached at times. The former type of policy is known as the *First Loss Policy* and the latter as the *Excess Policy.*

(vi) ***Blanket policy*** - A blanket policy is that which covers all assets - fixed as well as current - under one policy.

(vii) ***Comprehensive policy* -** A policy which covers risks such as fire, flood, riots, strikes, burglary etc. upto a certain specified amount is known as the comprehensive policy.

(viii) ***Consequential loss policy* -** The objective of this policy is to indemnify the insured against the loss or profit caused by any interruption of business due to fire. It is also known as *Loss of Profit Policy.*

(ix) ***Re-instatement policy* -** It is a policy under which the insurer pays the amount which is sufficient to re-instate assets or property destroyed.

(x) ***Open declaration policy* -** It is a policy whereby the insured makes a deposit with the insurer and declares the value of the subject matter in respect of which risk is covered.

Such policies are normally taken where the value of stocks etc. fluctuates considerably.

1.3.2 Marine Insurance

Marine insurance is perhaps the oldest type of insurance. Under a contract of marine insurance, **the insurance company or the underwriter agrees to indemnify the owner of a ship or cargo against risks which are incidental to marine adventure such as sinking or burning of the ship and its contents, stranding of the ship, collision of ship, Jettison,** *i.e.,* throwing overboard the cargo into the sea to save the ship from sinking or some other imminent danger, *barratry, i.e.,* wrongful act of the captain of the ship in destroying or stealing the vessel or cargo causing loss to owners.

Types of Marine Insurance - The common types of marine insurance are as follows :

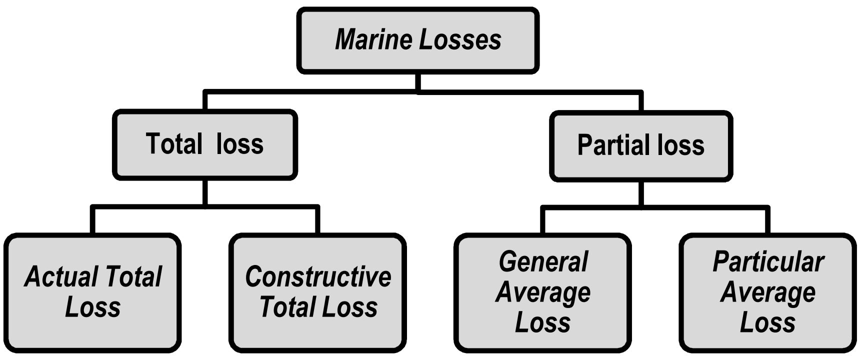
(*i*) ***Cargo insurance*** **-** This type of marine insurance covers risks to the cargo on the ship. The cargo on the ship is exposed to risks arising from an act of God, enemies, fire etc.

(ii) ***Hull insurance*** **-** The ship is also exposed to the perils described in (*i*) above. Therefore, the owner of the ship may effect 'hull' insurance to cover such perils.

(*iii*) ***Freight insurance*** **-** Where the owner of goods promises or undertakes to pay the freight when the cargo is safely delivered at the port of destination and the cargo is destroyed on the way, the shipping company would lose the freight. The shipping company can cover this risk by taking out a freight insurance policy.

The **persons who insure cargo, hull or freight are known as underwriters** because they write their name and sign at the foot of the policy. Originally, only individuals used to underwrite the policies in their own names. Later associations were formed for this purpose, the pioneer being the Lloyd's Association which was formed in 1774. In the year 1779, the Association adopted a definite policy known as the "Lloyd's policy" which is in use even now.

Types of Marine Losses **-** Marine losses may be broadly of two types –



(i) ***Total Loss*** *:* When the subject matter of insurance, *i.e.,* cargo, ship, freight etc. is totally lost, it is known as a 'total loss'. Total loss is also of two types:

   (a) ***Actual Total Loss*** - When the subject-matter of insurance is absolutely destroyed or totally lost to the insured, it is known as actual total loss.

(b) ***Constructive Total Loss*** - When the subject matter is not actually totally lost but is lost for all practical purposes *e.g.,* where the ship or cargo is reasonably abandoned and taken as lost or expenses to be incurred for saving the cargo or the ship are expected to be more than the value thereof, it is known as constructive total loss.

(ii) ***Partial Loss*** *:* When only a part of the subject matter is lost, it is known as partial loss. This loss may also be of two types as discussed below :

(a) ***General Average Loss*** **-** Such a loss is caused by extraordinary voluntary sacrifice made or expenditure incurred with the objective of protecting the interests of all owners in a voyage. An example of this type of loss is when the ship has run aground and part of the cargo is to be jettisoned to lighten the ship to save it as well as the cargo from total loss.

(b) ***Particular Average Loss*** **-** It is a partial loss of the subject matter of insurance caused by a peril against which it is insured but which is not a general average loss.

Types of Marine Insurance Policies - Generally a standard form for all policies is used for all marine insurance policies to cover various types of risks. However, differing needs of the insured have led to the evolution of a variety of marine insurance policies, the main among which are:

(i) ***Time policy*** **-** It is that policy which covers the risk of the subject matter for a specified period of time. It is generally used for hull insurance though it can be taken out also for cargo.

(ii) ***Voyage policy*** **-** This is a policy whereby the subject matter in transit is insured from one place to another. It is generally carried out for cargo which is exposed to marine risks in transit.

(iii) ***Mixed policy*** **-** This is also known as *time and voyage policy* as under this the subject matter on a particular voyage is insured for a specified period of time.

(iv) ***Floating policy*** **-** This policy is taken out by cargo owners who make regular shipments of cargo to insure the shipments expected to be shipped for a certain time by one policy. At the time the cargo is shipped, the insured declares the value of the shipment and the total value of the policy is reduced by that amount.

(v) ***Blanket policy*** **-** This policy is taken for a specified amount, the premium in respect of which is paid for the entire policy at the beginning itself and is adjusted at the end of the specified period for the value of risks covered during this period.

(vi) ***Fleet insurance policy*** - This policy insures the whole fleet of ships.

(vii) ***Open policy*** **-** This type of policy is taken out without specifying the value where at the time of insurance, the insured is not aware of the value of the subject matter to be insured, which is ascertained and declared to the insurer later. The insurance cover is subject to the limit of the sum assured.

(viii) ***Port policy*** **-** This policy covers the ship when it is docked/stationed at a port.

(ix) ***Composite policy* -** It is a policy underwritten by more than one underwriter. The liability of each underwriter is however distinct and separate.

(x) ***Valued policy* -** Under this policy, the value of the subject matter is agreed between the underwriters and the insured at the time of taking the policy and is specified therein.

***Clauses in a Marine Policy**:*

A marine policy may cover or exclude various types of risks. In view of this some special clauses may be inserted in the policy. Some of the important clauses are discussed below:

(i) ***Lost or Not Lost Clause* -** When this clause is inserted in the policy, the goods net insured irrespective of whether they are already lost or not lost before the policy is taken out. In other words, it covers loss of goods occurring between shipment of goods and the issuance of policy.

(ii) ***Waiver Clause*** - When this clause is included in a marine policy no act of the insurer or the insured in saving, maintaining and preserving the cargo or the hull will be considered as a "waiver", i.e., in case the insured takes steps under Sue, Labour and Travel clause after the notice of abandonment is given by him to the insurer but is not accepted by the insurer, it will not amount that the notice of abandonment is waived. Thus, if the insurer takes any such steps, it cannot be taken to mean as an acceptance of the notice of abandonment.

(iii) ***Permission to Touch and Stay Clause* -** As per this clause, the ship is permitted to touch and stay at the ports mentioned in the policy in the order specified therein. In case nothing is specified, the ship must touch and stay at ports which are normally touched in the particular trade. Any deviation from the route specified is permitted in an emergency to save the ship and the lives of the passengers.

(iv) ***Running Down Clause (RDC)* -** This clause enables the insured to claim the loss caused by collision with another ship.

(v) ***Free of Capture and Seizure Clause (FCS)* -** This clause is included in the policy to clarify that the underwriters will not be liable for any loss caused by ship being captured or seized in a war or warlike situation.

(vi) ***Continuation Clause* -** This clause may be included in a time policy whereby the ship will be covered until the end of the voyage or for not more than 30 days thereafter where the ship is still at sea at the time of expiry of the policy. A monthly *pro rata* premium is required to be deposited for this purpose.

(vii) ***Excepted Perils Clause* -** This clause specifies the risks not covered by the insurance policy.

(viii) ***Free of Particular Average (FPA) and Free of All Averages (FAA) Clauses* -** As the names suggest, the FPA clause exempts the underwriter from particular average and all averages, i.e., both general and particular average liabilities (discussed hereinafter).

(ix) ***Insurance Clause -*** This clause covers, among others, the losses caused by the negligence of master, crew etc. or by explosives or by other defects in machinery of the ship.

(x) ***Jettison Clause -*** This clause covers the loss caused by jettisoning of goods, i.e., throwing overboard goods to reduce the weight of the ship and prevent capture by the enemy.

(xi) ***Barratry -*** This clause covers all losses caused by willful misconduct or defaults of the master and crew of the ship.

1.3.3 Miscellaneous Insurance Policies

In addition to the types of general insurance business discussed above, there are a number of insurance policies which cover various other types of risks, the important ones of which are discussed hereinafter.

Motor Vehicle Insurance - Motor Vehicle insurance policies are normally taken out to cover two types of risk—(*i*) the risk of damage by an accident or loss by theft, and (*ii*) risk of liability arising from an injury or death of any person in an accident caused by a vehicle, commonly known as Third Party Insurance. The owner of a vehicle is compulsorily required to get third party insurance under the Indian Motor Vehicles Act whereas the other types of insurance are voluntary.

Fidelity Insurance - This type of insurance protects an employer against the frauds, defalcations etc., on the part of his employees where, as part of their employment obligations, such employees are required to handle cash, goods or other valuables of the employer.

Credit Insurance - Credit insurance is taken out to protect the insured against the losses caused by bad debts due to insolvency of the debtors or otherwise.

Burglary Insurance - Burglary insurance policy is issued whereby the insurer undertakes to indemnify the insured against losses from burglary, i.e., the removal of movable goods by theft or burglary.

Loss of Profit Insurance - Loss of profits insurance is often accompanied by fire insurance and it covers the risk of loss of profits caused by fire, including fixed costs which are continued to be incurred till the business starts functioning at its normal level.

Workmen's Compensation Insurance - This type of insurance covers the risk of liability arising on account of payment of compensation where a worker suffers injury or dies in an accident in the course of his employment.

Professional Liability Insurance - Professional liability insurance protects the professionals, such as doctors, lawyers and accountants, against the risk of liabilities arising towards clients of third parties in connection with their work. This may also include legal expenses incurred in defending law suits.

The scope of miscellaneous insurance business is very wide and encompasses almost all commercial activity.

Important points to be remembered

- Only in general insurance policy the insured gets compensation only in case of loss sustained by him due to reasons specified in the policy.
- In India life insurance business can be conducted only by the Insurance Corporation of India, set up under an Act of Parliament; general insurance business is also taken over by the Government and four general insurance companies are now in operation with General Insurance Corporation of India as the holding company.

1.4 Distinction between Life Insurance and Other Forms of Insurance

		Life Insurance	Other Insurance
1.	Timing of Payment of Claim	Insurable amount is payable either on the happening of the event (death) or at the maturity	Reimbursement of loss or liability incurred will be paid at the happening of the uncertain event only.
2.	Value of Policy	Insurance can be done for any value depending upon the premiums the insured is willing to pay.	The sum payable under it is limited to the amount of loss actually suffered or the liability incurred, notwithstanding the amount of policy.
3.	Duration of Contract	-These are long term contracts running over the number of years.	These are only for one year though renewable after year.
4.	Assurance	Life insurance is known also by another term 'assurance' since the insured gets an assured sum.	Other policies are known as insurance.
5.	Determination of Liability	Actuaries periodically estimate the liability under existing policies. On that basis a valuation balance sheet is prepared to determine the profit	A portion of the premium is carried forward as a provision for unexpired liability and the balance net of claims and expenses is taken as profit or loss.

1.5 Some Relevant Provisions of the Insurance Act, 1938

The general insurance business in India is governed by the Insurance Act, 1938 which is based on the British Insurance Act. The Act was amended in 1969 for 'social control' to govern the general insurance business on healthy lines. However, it was felt that there still existed some scope for improvement. In view of this, on May 13, 1971 the government nationalised the general insurance industry by an ordinance which became the General Insurance (Nationalisation) Act, 1972. At that time there were 63 domestic insurance companies and 44 foreign insurance companies operating in India. The managements of all the 107 companies were taken over by the Government and accordingly the General Insurance Corporation (GIC) was formed as a government company in November 1972. The GIC as the holding company is entrusted with the task of superintending, controlling and carrying on the general insurance business in the country. Its subsidiaries in all the four zones of the country viz., the Oriental Fire & General Insurance Company (now known as the Oriental Insurance Co. Ltd.), the National Insurance Company Ltd., the New India Assurance Company Ltd. and the United India Insurances Company do all classes of direct business of general insurance except aviation which is done by the GIC.

The Insurance Act, 1938 and the rules framed there under have an important bearing on the preparation of accounts of insurance companies. Some of the provisions have become irrelevant after the nationalization of general insurance. Some provisions have been amended by IRDA Act, 1999 and these have been separately listed.

(1) ***Forms for final accounts [Section 11(1)].*** Every insurer should prepare the balance sheet in accordance with the regulations contained in Part I of the First Schedule and in form set forth in Part II of that Schedule. The balance sheet provides three columns, namely life and annuity business, other classes of business and total. Profit and loss account and the appropriation account are to be prepared in form B and C respectively given in Part II of the same schedule. Revenue accounts are to be prepared in accordance with the forms given in the Third Schedule in respect of each class of insurance business. These forms are given in relevant sections.

(2) ***Audit:*** The Act provides that the company carrying on general insurance business be audited as per the requirements of the Companies act, 2013.

(3) ***Register of policies (Section 14):*** Every insurer must maintain a register of record of policies showing in respect of every policy, the names and addresses of policyholders, the date when the policy was effected and record of any transfer, assignment or nomination of which the insurer has notice.

(4) ***Register of claims:*** The insurer must also maintain a register of claims, giving the details of claim made such as date of the claim, the name and address of the claimant and the date on which the claim was discharged. If the claim was rejected, the date of rejection and the reasons there for. Apart from these there are other statutory records to be maintained and they are listed in a separate section.

(5) ***Approved investments (Section 27B):*** A company carrying on general insurance business must invest its funds only in approved securities listed in this section.

(6) ***Payment of commission* to *authorized agents (Section 40):*** The Act prohibits payment of commission to any person other than authorized agent for soliciting or procuring business, subject to a maximum of 15% of the premium.

(7) ***Limit on expenditure [Section 40A(3)]:*** Expenditure by way of commission which normally ranges within the limits of 5 to 15% subject to the review by GIC.₹ Sec. 40C of the Insurance Act, 1938 prescribes the limitation on expenses of management in general insurance business. Rule 17E of the Insurance Rules, 1938 provides for the computation of the limit on expenses of management. A certificate signed by the chairman and two directors must state that all expenses of management have been fully debited to the revenue account.

(8) Section 64VA of the Insurance Act, 1938 requires every insurer to maintain an excess of the value of its assets over the amount of its liabilities at all times. The excess is known as **solvency margin.**

1.6 Insurance Regulatory and Development Authority Act, 1999 (Some Relevant Amendments In Insurance Act, 1938)

The Insurance Regulatory and Development Authority Act, 1999 is an act to provide for the establishment of an Authority to protect the interests of holders of insurance policies, to regulate, promote and ensure orderly growth of the insurance industry and for matters connected therewith or incidental thereto and further to amend the Insurance Act, 1938 the Life Insurance Corporation Act, 1956 and the General Insurance Business (Nationalisation) Act, 1972 to end the monopoly of the Life Insurance Corporation of India (for the insurance business) and General Insurance Corporation and its subsidiaries (for general insurance business).

The Act was published in the Gazette of India on 29th Dec., 1999 and extends to the whole of India. Words and expressions used and not defined in this Act but defined in the Insurance Act, 1938 or the Life Insurance Corporation Act, 1956 or the General Insurance Business (Nationalisation) Act, 1972 shall have the meanings respectively assigned to them in those Acts.

Applicable to	Schedule A Life Insurance Business	Schedule B General Insurance Business
Premium is recognised	When due	• Over contract priod or period of risk • Unearned premium is a Current Liability and Reserve have to be created for it. • Premium in advance is also a Current Liability
Premium deficiency is recognised if:	Expected claims + Expenses etc. are more than expected premium.	Expected claims + Expenses, etc, are more than expected

		premium for contracts more that 4 years, it used actuarial valuation.
Acquisition Cost = Expenses acquiring or renewal policy	Expenses in the year in which they are incurred	Expenses in the year in which they are incurred.
Claims	Policy Benefit Amount + Claim settlement cost	Claims for losses incurred + Settlement cost + Claims incurred but not Reported (IBNR) + Claims incurred but not enough reported (IBNER) treated in Outstanding claims.
Actuarial Valuation	If for LIP business in force certificate for liability is in pursuant to annual inviting of LIB. Assumption is noted to account.	Actuarial valuation is required for contracts more than 4 years. Necessary provision for unexpired risk may be made.
Investment a) Real Estate Investment Properties	• Valued at historical cost • Revaluation in 3 years; transfer to Revaluation Reserve. • Profit on investment = Revaluation Reserve + Profit above carrying amount. • Revaluation Reserve is not available for Shareholder but it is available for Policyholder to certain extent as bonus. • Impairment loss is transferred to Profit and Loss Account • Impairment losses on revalued asset is transferred to revaluation Account	• Valued at historical cost (-) Depreciation (-) impairment loss • Impairment loss is transferred to Profit and Loss Account. • No Revaluation is required
b) Debt Security including Govt. Securities and Preference Share Capital	Considered as held to maturity and measured at historical cost subject to amortisation.	
c) Equity Security and derivative Instruments traded activity	• Measured at Fair Market Value (FMV) • FMV = Least of closing	• Measured at FMV • FMV = Least of closing prices on stock exchange

(Unit sold/purchased more 10,000 units per annum)	prices on the stock exchange • Unrealised gain / losses due to changes in FMV is taken to Fair Value Change A/c. • The actual profits/loss on the sale of investment and Fair value change account is transferred to Revenue/ Profit and Loss. Till then FVC A/c is not available to Shareholders for dividend and only specific available for bonus for policyholders.	• Unrealised gains/loss due to change in FMV is taken to Fair Value Change Account. • The actual Profit or Loss on the sale of investment and FVC account is transferred to Profit and Loss Account. • Till then FVC Account is not available for dividend • For declaring the dividend, the company can use free Reserve Debts of FVC account.
d) Unlisted and other non-actively traded equity shares and derivatives Instruments. (Non-active if trading Vol. does not exceed 10,000 units of that securties)	• Kept at historical cost • Provision for diminution it can be reversed in case of increase but the carrying amount cannot be more than historical cost.	• Kept at Historical cost • Provision for diminution is made if decrease in value. The carrying amount cannot exceed historical cost.
Loans	• At historical cost subject to impairment provision. • Provision for impairment = Loan for which: 1. Interest remaining unpaid over 6 months. 2. Interest falling due and unpaid for 6 months.	• At historical cost subject to impairment provision. • Provision for impairment = Loan for which: 1. Interest remaining unpaid over 6 months. 2. Interest falling due and unpaid for 6 months.
Catastrophe Reserve		It has to be created in accordance of norms and used for meeting unexpected losses which are not specified and known in advance.
Linked Business	Valuation of interest on principle above. A separate set for each segregated fund means investment for policyholders who bear investment risk.	

Important amendments made to the earlier Act by the IRDA Act, 1999

(1) It is mandatory for every Insurer on or after the commencement of this Act, to prepare a balance sheet, a profit and loss account, a separate receipts and payments account, a revenue account in respect of insurance business transacted by him and in respect of his shareholders funds. The accounts are to be prepared for every financial year instead of the calendar year. The accounting year has already been changed to financial year when insurance companies prepared the accounts for 15 months ending with the financial year 1988-89, in response to Government directive. The directive might have become necessary because of the change in the previous year effected by Income Tax Act. The Act was amended requiring previous year to be the financial year.

(2) Every insurer must keep separate accounts relating to funds of shareholders and policyholders.

(3) Insurers are prohibited from investing either directly or indirectly their funds outside India.

(4) The Regulatory Authority has the power to direct the insurers to invest funds in infra structure and social sectors subject to certain conditions. The authority in general has the power to direct the time, manner and other conditions of investment with a view to protect the interests of policyholders. The amendment raises commission on fire and marine policies from the previous 10% to 15%.

(6) There is a necessity for insurers to keep a required solvency margin. The margin refers to the excess of assets over liabilities. If an insurer does not maintain such a margin, he has to submit a financial plan indicating a plan to correct the deficiency. If these requirements are not met to the satisfaction of the Authority, the insurer may be deemed to be insolvent and the company may be wound up by the court.

(7) Every insurer must submit to the Authority a prescribed return certified by an actuary in the case of life business and certified by an auditor in the case of general insurance business to show that the required solvency margin has been maintained.

(8) Every insurer carrying on general insurance business is required to create a 'Catastrophe Reserve' to meet the future potential liability against the insurance policies in. force. This reserve is not created for any specific or known purpose. Creation of this reserve should be in accordance with the regulations issued by the Authority. So far the Authority has not issued any regulation in this regard.

It may be noted that the Union Cabinet had approved the promulgation of the Insurance Laws (Amendment) Ordinance 2014 to amend the Insurance Act, 1938, the General Insurance Business (Nationalisation) Act, 1972 and the Insurance Regulatory and Development Authority Act, 1999, in accordance with the Insurance Laws (Amendment) Bill 2008.

The Ordinance is aimed at amending the Insurance Act, 1938, the General Insurance Business (Nationalization) Act, 1972 and the Insurance Regulatory and Development Authority Act, 1999 to remove archaic and redundant provisions in the Insurance Laws,

empower IRDA to enable more effective regulation and enhance the foreign equity investment cap in an Indian Insurance Company from 26 to 49% with the safeguard of Indian ownership and control.

References:

Study on Audit of companies carrying on General Insurance Business published by the Institute of Chartered Accountants of India; Insurance Act, 1938; General Insurance (Nationalisation) Act, 1972; Life Insurance Corporation Act, 1956; and Insurance Regulatory and Development Authority Act, 1999, Insurance Regulatory and Development Authority Regulations, 2002 .

Summary

- ***Claims:*** it refers to the amount payable by insurer to the insured when policy becomes due or the mishappening occurs.

  Claim = Claim intimated + Survey fees + Medical expenses – Claims received on insurance.

- ***Premium*****:** it refers to the consideration received by the insurance company to undertake the risk of the loss. It is always net of premium paid on reinsurance.

- ***Annuity (LIC):*** it is fixed annual payment received regularly till insured lives. This is in consideration of lumpsum money paid by him in the beginning of the policy.

- ***Bonus:*** the profit of LIC is distributed among the shareholders and policy holders. The policy holders get 95% of the profit of LIC by way of bonus. The bonus may be of following types:

  - *Cash Bonus:* paid on declaration of bonus in cash.
  - *Revisionary Bonus:* it is paid with the policy maturity instead of cash amount now. This bonus is added in the amount of claims.
  - *Bonus in reduction of Premium:* Bonus is not paid in cash but adjusted against the future premiums.
  - *Interim Bonus:* it refers to bonus paid on the maturity of policy in the year for which the profit has not yet been determined. Such a bonus is included in claims.

- ***Reinsurance*** *:* if an insurer is not willing to bear the whole of the risk, it reinsure itself. Some risk retains with some other insurer.

Unit - 2 : Accounting Technique of General Insurance Business

Learning Objectives

After studying this unit, you will be able to:

- Understand the issues involved in the general insurance and learn the books of accounts/records which should be maintained at the divisional office of a general insurance company.
- Familiarize with the format of claim statement and try to understand how to compile the claim provisions.
- Understand the meaning of claims paid, co-insurance, outstanding premium and commission. Insurance companies debit all management expenses to a control account in the general ledger. Learn the technique of accounting of the management expenses and analysis thereof.
- Be familiar with the details of loans and investments of an insurance business and the books and records normally maintained in the investment department of an insurance company.
- Learn the technique of creating unexpired risks reserve in case of fire, marine, and miscellaneous insurance business.
- Understand the concept of re-insurance

2.1 Functional Divisions and Books of Accounts Maintained Therein

Considering the nature and spread of the general insurance business, the four subsidiaries of the General Insurance Corporation operate through their Head Offices, Regional/Area Offices, Divisions and Branches attached thereto.

The most important part of the business operations comprises the issuance of policies for risks assumed and to indemnify the insured for losses to the extent covered by such policies. In financial terms these operations get translated into—

(a) the receipt/recording of premium income; and

(b) the recording and settlement of claims for losses.

The business operations stated above are essentially confined to the divisional offices and the branches attached to these divisions. The accounting for these operations in these offices involve recording of premium income and provisions and payments in respect of claims under policies. Transactions related to operations at the branches are communicated for accounting thereof at the divisions. Generally, separate bank accounts are maintained for premium collections and for disbursement of expenditure. Normally, collections are transmitted to the relevant controlling office and the concerned account is not normally operated upon for expenditure etc. The branches of the divisions submit adequate information and evidence of transactions relating to their operations. The returns from the branches will include all transactions by way of documents relating to premium received, claims provisions and payments and operation of bank accounts.

The following books of account/records are normally maintained at a divisional office:

(i) Cash Receipt Book.

(ii) Cash Disbursement Book.

(iii) Dishonoured Cheque Register.

(iv) State Cheque Register.

(v) Daily Cash Balance Book.

(vi) Claims Disbursement Book.

(vii) Premium Register.

(viii) Bank Transfer Journal.

(ix) Journal.

(x) Summary Books for incorporation of Branch Returns (Cash Receipt Statements, Cash Disbursement Statements and Premium Register after these are duly checked).

(xi) General Ledger.

(xii) Sub-Ledgers.

(xiii) Register for Analysis of Management Expenses.

(xiv) Cash Receipts, Cash Disbursement Vouchers and Journal Vouchers.

(xv) Remittances Received Register.

(xvi) Salvage Register.

(xvii) Claims Recovery Register.

(xviii) Stationary Register.

(xix) Trunk Call Register.

(xx) Assets Register.

(xxi) Policy Stamp Register.

(xxii) Excess/Shortage Register.

(xxiii) Co-insurers Register.

Other major areas of accounting involve accounting for investments, reinsurance and other administrative matters which are dealt with at the Head Office.

2.2 Claims Provision at Divisional Offices

The outstanding liability at the year-end is determined at the divisions/branches where the liability originates for outstanding claims. Thereafter, based on the total consolidated figure for all the divisions/branches, the Head Office considers a further provision in respect of outstanding claims.

Every division prepares a claims statement.

To cover the possibility of errors in judgement in estimation or in cases of under-estimation of liability (where full details are not available) as also for the possibility of liability not being considered for claims incurred but not reported due to the nature of risks being such (e.g., where communication is made after a considerable time lag or after the cut-off date for preparation of final accounts) the company at its head office makes an additional provision over and above that made by Divisions/Branches on the Divisional Auditors' Reports. Such liability is presently being cushioned to the extent of 5.5% in respect of Fire, Marine and Miscellaneous business (excluding motor, engineering, aviation, hull and credit guarantee) and 10.5% for motor and engineering business.

In view of the above, total of outstanding claims comprises the estimated liability recorded at the Divisions/Branches and the further provision made on this account at head office. This provision is subject to the amount to be adjusted for re-insurances, which are dealt with at head office.

2.3 Claims Paid

For each class of business, the insurance companies have to disclose, in the relevant revenue accounts, claims paid separately. The divisional offices first ascertain the genuineness of the claim and ensure completion of the necessary formalities to enable the settlement to be made. Relevant evidence in respect of each claim is retained in each claim file and the liability is discharged after obtaining sanction of the relevant authority on the basis of amounts involved.

The divisional offices are expected to submit to the Head Office, for re-insurance adjustments, statements at regular intervals as to claims paid or provided for. Sometimes a year-end statement is also prepared showing month-wise figures so communicated.

A liability for outstanding claims shall be brought to accounts in respect of both direct business and inward reinsurance business.

The liability shall include:

(a) Future payments in relation to unpaid reported claims;

(b) Claims Incurred But Not Reported (IBNR) including inadequate reserves [sometimes referred to as Claims Incurred But Not Enough Reported (IBNER)], which will result in future cash/asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liability for outstanding claims at the beginning and at the end of the financial period.

At the end of each financial year, as required by IRDA the actuarial valuation of the claims liability of an insurer is made by the appointed actuary, and the shortfall, if any is provided as IBNR/IBNER.

2.4 Co-Insurance

In cases of large risks the business is shared between more than one insurer under co-insurance arrangements at agreed percentages. The leading insurer issues the documents, collects premium and settles claims. Statements of Account are rendered by the leading insurer to the other co-insurers. Accounting for premium, claims etc. under co-insurance is done in the same manner as that of the direct business except in respect of the following peculiar features.

Incoming Co-insurance

(i) ***Premium -*** The co-insurer books the premium based on the statement received from the leading insurer usually by issuing dummy documents. Entries are made in the Premium Register from which the Premium Account is credited and the Leading Insurer Company's Account debited. In case the statement is not received, the premium is accounted for on the basis of advices to ensure that all premium in respect of risk assumed in any year is booked in the same year; share of premium relatable to further extension/endorsements on policies by the leading insurer are also accounted for on the basis of subsequent advices. Reference to the relevant communications should be made from the concerned companies to ensure that premium collected by them and attributable to the company is recorded.

(ii) ***Claims Provisions –*** Refer para 2.2.

(iii) ***Claims Paid -*** Normally, on the basis of claims paid, advices received from the leading insurer, the Claims Paid Account is debited with a credit to the co-insurer. All such advices are entered into the Claims Paid Register. It is a practice to treat all claims paid advices relating to the accounting year received upto 31st January of the subsequent year from leading insurer as claims paid.

Outgoing Co-insurance

The share of the insurer only for both premium and claims has to be accounted under respective accounts. The share of other co-insurers is credited or debited, as the case may be, to their personal accounts and not routed through revenue accounts.

2.5 Outstanding Premium

This should normally comprise amounts due for uncollected premium where the company is allowed relaxation to the provisions of Section 64VB of the Insurance Act, 1938. The outstanding balances are expected to be temporarily outstanding and should be recovered within the stipulated period after the year-end. There may however be cases of premium otherwise receivable and due but which remains uncollected at the year-end.

(a) ***Bank guarantee limits available -*** Premium in respect of risk accepted under Bank Guarantee and Cash Deposit received either directly or through agents is accounted for with reference to the limits available. Normally, monthly statements are prepared and

submitted to every party and the balances of outstanding premium are recovered before the close of the following month. Outstanding premium in excess of bank guarantee available should be reported.

(b) ***Cash Deposit* -** The balance of this account is always credit except in cases where the premium due exceeds the cash deposits resulting in debit balance recoverable from the party. Debit balance in the cash deposit account is shown separately since they are classified separately with the debit balance under outstanding premium on the assets side of the balance sheet.

2.6 Commission

Section 40A(3) of the Insurance Act, 1938, deals with and prescribes the basis and rates of commission payable to agents. However, under the provisions of General Insurance Nominalisation Act, the G.I.C. is empowered to regulate the commission structure.

It may be noted that all expenses of management are debited to a control account in the general ledger under "Expenses of Management" with a supporting subsidiary ledger viz., "Analysis of Management Expenses" wherein expenses for each classified category are posted and reconciled with the control account. Management Expenses Accounts Classification Schedule is normally annexed to the Trial Balance and forms a part thereof. Such expenses are shown separately under fire, marine and miscellaneous revenue accounts apportioned as recommended by the Guidelines framed by the General Insurance Corporation for this purpose, and as to the basis of such apportionment, a note is appended to the accounts. Provision for outstanding expenses is made at the divisional office level.

2.7 Loans

Part II of the First Schedule to the Insurance Act, 1938, requires the following items to be disclosed in the balance sheet:

Loans:

On mortgages of property within India.

On mortgages of property outside India.

On security of municipal and other public rates.

On stocks and shares.

On Insurer's policies within their surrender value.

On personal security.

To Subsidiary Companies (other than Reversionary).

Reversions and Life Interests purchased.

Loans on Reversions and Life Interests.

Debentures and Debenture stocks of Subsidiary Reversionary Companies.

Ordinary stocks and share of Subsidiary Reversionary Companies.

Loans to Subsidiary Reversionary Companies.

Besides the above items the present practice is also to disclose loans to industrial undertakings in India on consortium basis with the GIC and the four subsidiary companies and/or other financial institutions. Term loans may often be preceded by bridge loans to such undertakings pending completion of all formalities.

Except for housing and other loans to staff which may be recorded at the Divisions/Regional level other loans are usually dealt with at Head Office.

2.8 Investments

Investments in general insurance companies are governed by the provisions of Section 27B of the Insurance Act, 1938 as well as by the guidelines issued from time to time by the Ministry of Finance through General Insurance Corporation of India.

The various types of investments normally included in the Balance Sheet are given below:

1. Deposit with the Reserve Bank of India (Securities to be specified)
2. Indian Government Securities/State Government Securities
3. British, British Colonial and British Dominion Government Securities
4. Foreign Government Securities
5. Indian Municipal Securities
6. British and Colonial Securities/Foreign Securities
7. Bonds, Debentures, Stocks and other securities whereon Interest is guaranteed by the Indian Government or State Government
8. Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by the British or any Colonial Government
9. Bonds, Debentures, Stocks and other Securities whereon Interest is guaranteed by any Foreign Government
10. Debentures of any Railway in India
11. Debentures of any Railway out of India
12. Preference or guaranteed Shares of any Railway in India
13. Preference or guaranteed Shares of any Railway out of India
14. Railway Ordinary Stocks (*i*) in India (*ii*) out of India
15. Other Debentures and Debenture Stock of Companies incorporated (*i*) in India (*ii*) out of India
16. Other Guaranteed and Preference Stocks and Shares of Companies incorporated (*i*) in India (*ii*) out of India

17. Other Ordinary Stocks and Shares of Companies incorporated (*i*) in India (*ii*) out of India
18. Holdings in Subsidiary Companies.

As per the Guidelines presently applicable, the investible funds have to be invested on the following pattern (as per Insurance Regulatory & Development Authority (Investment) (fifth amendment) Regulations, 2013:

No.	Type of investment	Percentage of Investment Assets
(i)	Central Government Securities	Not less than 20%
(ii)	Central Government Securities, State Government Securities and other approved securities	Not less than 30% (including (i) above)
(iii)	Approved investments as specified in Section 27B of the Act and and Other Investment as specified in Section 27B(3) of the Act and Schedule II to these Regulations, (all taken together) subject to Exposure /Prudential Norms as specified in Regulation 9.	Not exceeding 70%
(iv)	Other investments as specified under Section 27B (3) of the Act, subject to Exposure I Prudential Norms as specified in Regulation 9.	Not more than 25%
(v)	Housing and loans to State Government for Housing and Fire Fighting equipment, by way of subscription or purchase of **A. Investments in Housing** a. Bonds / Debentures issued by HUDCO, National Housing Bank b. Bonds/Debentures of Housing Finance Companies either duly accredited by National Housing Banks, for house building activities, or duly guaranteed by Government or carrying current rating of not less than 'AA' by a credit rating agency registered under SEBI (Credit Rating Agencies)Regulations,1999 . c. Asset Backed Securities with underlying Housing loans, satisfying the norms specified in the Guidelines issued under these regulations from time to time. I	Total Investment in housing (i.e.,) investment in categories (i), (ii), (iii) and (iv) above taken together. shall not be less than 5% of the investment Assets.
	B. Investment in Infrastructure (Explanation: Subscription or purchase of Bonds Debentures, Equity and Asset Backed Securities with underlying infrastructure assets would qualify for the purpose of this requirement. 'Infrastructure facility' shall have the meaning as given in clause (h) of regulation 2 of Insurance Regulatory and Development Authority	Total investment in Infrastructure (i.e.,) investment in categories (i), (ii),(iii) and (iv) above taken together shall not be less than

	(Registration of Indian Insurance Companies) (Amendment) Regulations. 2008 as amended from time to time.	10% of the Investment Assets
	Note: Investments made under category (i) and (ii) above may be considered as investment in housing or infrastructure, as the case may be. provided the respective government issues such a security specifically to meet the needs of any of the sectors specified as 'infrastructure facility'	

On the basis of estimates made at the beginning of the year, the investments are made accordingly in each category. The estimates are reviewed and revised periodically if necessary.

The following books and records are normally maintained in the Investment Department of the Head Office of a company carrying on general insurance business.

(1) Contracts (Bought/Sold Notes)

(2) Copies of the Delivery Instructions

(3) Purchase Registers

(4) Application Money Registers

(5) Allotment and Call Money Registers

(6) Rights Issue/Bonus Issue Registers

(7) Sales Redemption Registers

(8) Term Loans Registers

(9) Fixed Deposits/Participation Certificates/Bills Register

(10) Underwriting Registers

(11) Dividend Reconciliation Register

(12) Interest Reconciliation Register

(13) Safe-custody Receipts issued by banks

(14) Cash Book/Bank Book

(15) Investments sub-ledgers

(16) General Ledgers

(17) Investment Schedules, classified as to nature of investments.

2.9 Unexpired Risks Reserve

Insurance Company, close their accounts on 31st March but not all risks under different policies expire on that date. Many policies extend into the following accounting year during which the risk continues. Therefore on the closing date there is an unexpired liability under various policies which may occur during the remaining term of the policy beyond the year and therefore, a provision for unexpired risks is made. This reserve is based on the Net Premium income earned by the insurance company during the year.

The effort involved in calculating unexpired portion of premium under each policy is very time consuming. Therefore, a simple formula to derive a percentage of premium income to be allocated to reserve for unexpired risks is adopted.

According to the requirements of the Insurance Act, it is sufficient if the provision is made for unexpired risks at 50 per cent for Fire, Marine Cargo and Miscellaneous business except for Marine Hull which has to be 100 per cent. It may be mentioned that the insurance companies are governed by the provisions of Section 44 of the Income-tax Act, 1961. In this regard, Rule 5 of the First Schedule to the Income-tax Rules — computation of Profit & Loss of General Insurance Business — provides for creation of a reserve for unexpired risks as prescribed under Rule 6E of the said Rules. According to this Rule, the insurance companies are allowed a deduction of 50 per cent of net premium income in respect of Fire and Miscellaneous Business and 100 per cent of the net premium income relating to Marine Insurance business. In view of this the reserves are created at the rates allowed under the Income-tax Act.

Additional reserve for unexpired risk

- In a particular year the management may feel that the percentage of premium recommended by the General Insurance Council is not sufficient to meet the unexpired risks. In such a situation they may provide additional reserve. Such additional reserve for unexpired risk will also be debited to the revenue account.
- The balance will be shown in the balance sheet as in the case of normal reserve for unexpired risk, and will be transferred to the credit of next year's revenue account.

Illustration 1

Indian Insurance Co. Ltd. furnishes you with the following information :

(i) On 31.12.2011 it had reserve for unexpired risk to the tune of ₹ 40 crores. It comprised of ₹ 15 crores in respect of marine insurance business : ₹ 20 crores in respect of fire insurance business and ₹ 5 crores in respect of miscellaneous insurance business.

(ii) It is the practice of Indian Insurance Co. Ltd. to create reserves at 100% of net premium income in respect of marine insurance policies and at 50% of net premium income in respect of fire and miscellaneous income policies.

(iii) During 2012, the following business was conducted :

	Marine	*Fire*	*Miscellaneous (₹ in crores)*
Premia collected from :			
(a) Insureds in respect of policies issued	*18*	*43*	*12*
(b) Other insurance companies in respect of risks undertaken	*7*	*5*	*4*
Premia paid/payable to other insurance companies on business ceded	*6.7*	*4.3*	*7*

Indian Insurance Co. Ltd. asks you to :

(a) Pass journal entries relating to "Unexpired risks reserve".

(b) Show in columnar form "Unexpired risks reserve" a/c for 2012.

Solution

(a) Journal of Indian Insurance Co. Ltd.

(₹ in crores)

2012			*Dr.*	*Cr.*
Dec. 31	Marine Revenue A/c	Dr.	3.30	
	To Unexpired Risks Reserve A/c			3.30
	(Being the difference between closing provision of ₹ 18.30 crores (18 + 7 – 6.7) and opening provision of ₹ 15 crores charged to marine revenue account)			
	Fire Revenue A/c	Dr.	1.85	
	To Unexpired Risks Reserve A/c			1.85
	(Being the difference between closing provision of ₹ 21.85 crores [(43 + 5 – 4.3)/2] and opening provision of ₹ 20 crores charged to fire revenue account)			
	Unexpired Risks Reserve A/c	Dr.	0.50	
	To Miscellaneous Revenue A/c			0.50
	(Being the excess of opening balance of ₹ 5 crores over the required closing balance of ₹ 4.5 crores [(12 + 4 – 7)/2] credited to miscellaneous revenue account).			

(b) Unexpired Risks Reserve A/c

(₹ in crores)

2012		*Marine* ₹	*Fire* ₹	*Miscel-laneous* ₹	*2012*		*Marine* ₹	*Fire* ₹	*Miscel-laneous* ₹
Dec. 31	To Revenue A/c	–		0.5	Jan 1	By Balance b/d	15.00	20.00	5.00
	To Balance c/d	18.30	21.85	4.50	Dec. 31	By Revenue A/c	3.30	1.85	–
		18.30	21.85	5.00			18.30	21.85	5.00

Note : Alternatively, the opening balances of unexpired risk reserves may be reversed in the beginning of year by transfer to Revenue account and fresh reserve of full required amount may be created at the end of the year which will be carried forward as closing balances.

2.10 Re-Insurance

In general insurance there are risks which, because of their magnitude or nature, one insurance company cannot afford to cover, e.g., aviation insurance. Generally, in such cases, an insurance company insures the whole risk itself and lays off the amount it has accepted to other insurance of reinsurance companies, retaining only that much risks which it can absorb.

A reinsurance transaction may thus be defined as an agreement between a 'ceding company' and a 're-insurer' whereby the former agrees to 'cede' and the latter agrees to accept a certain specified share of risk or liability upon terms as set out in the agreement.

A 'ceding company' is the original insurance company which has accepted the risk and has agreed to 'cede' or pass on that risk to another insurance company or a reinsurance company. It may however be emphasized that the original insured does not acquire any right under a reinsurance contact. In the event of loss, therefore, the insured's claim for full amount is against the original insurer.

In other words, if an insurer is not willing to bear the whole of the risk, it reinsures itself. Some risk retains with some other insurer. This is called as reinsurance. Both re-insurer and original insurer share the premium and risk in the same proportion and decided by them earlier.

The accounting entries pertaining to re-insurance business ceded to and by an insurance company may be explained with the help of an example:

(X insurance company cedes re-insurance business to Y insurance company and Z insurance company cedes re-insurance business to X insurance company.) Accounting entries pertaining to re-insurance business ceded to and by X insurance company in the above example may be given as follows:

In the books of X Insurance Company

X Insurance company cedes reinsurance business to Y:-

1. *Re--Insurance Premium (on reinsurance ceded) A/c Dr. xxxx*

   To Y Insurance Co xxxx

   (Being premium on reinsurance business ceded to Y Insurance Co recorded)

2. *Y Insurance Co A/c Dr. xxxx*

   To Commission (on Reinsurance ceded) xxxx

   (Being commission due on re-insurance business ceded to Y Insurance Co recorded)

3. *Y Insurance Co A/c Dr. xxxx*

   To Claims (on reinsurance ceded) xxxx

   (Being claims receivable from Y Co. for part of insurance business ceded)

Z Insurance company cedes reinsurance business to X:-

1. *Z Insurance Co A/c Dr. xxxx*

   To Re-Insurance premium (on reinsurance accepted) xxxx

   (Being premium on business ceded by Z insurance company recorded)

2. *Commission (on Reinsurance ceded) Dr. xxxx*

   To Z Insurance Co xxxx

   (Being commission due on re-insurance business ceded to Z company debited)

3. *Claims (on reinsurance accepted) A/c Dr. xxxx*

   To Z Insurance Co xxxx

   (Being claims on re-insurance business accepted from Z company recorded)

Illustration 1

Janani Assurance Co. Ltd. received ₹ 5,90,000 as premium on new policies and ₹ 1,20,000 as renewal premium. The company received ₹ 90,000 towards reinsurance accepted and paid ₹ 70,000 towards reinsurance ceded. How much will be credited to Revenue Account towards premium?

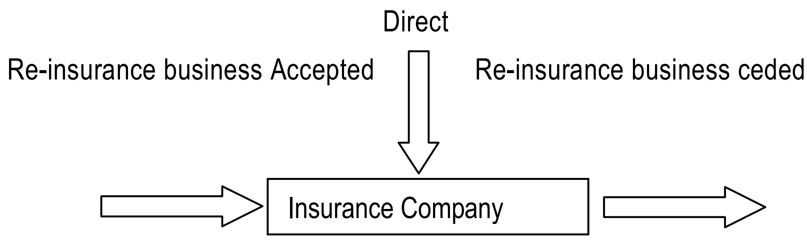
	₹
Premium received in respect of new policies	5,90,000
Add: Renewal premium	1,20,000
	7,10,000
Add: Re-insurance premium accepted	90,000
	8,00,000
Less: Re-insurance ceded	(70,000)
Premium amount to be credited to Revenue A/c	7,30,000

Broadly speaking, there are two types of reinsurance contracts:

1. Facultative Reinsurance : It is that type of reinsurance whereby the contract relates to one particular risk and is expressed in a reinsurance policy.. Each transaction under Facultative Reinsurance has to be negotiated individually and each party to the transaction has a free choice, i.e. for the ceding company to offer and the reinsurer to accept. The main drawback of this type of insurance is the volume of work involved and time taken to cover the risk.

2. Treaty Insurance: Under this type of reinsurance a Treaty agreement is entered into between ceding company and the re-insurer(s) whereby the reinsurances are within the limits of the Treaty. These limits can be monetary, geographical, section of business, etc. Under this contract it is obligatory for the re-insurer to accept all risks within the scope of this Treaty and it is obligatory for the ceding company to cede risks in accordance with the terms of the Treaty.

Treaties can also be divided into two categories, viz. proportional treaties and non-proportional treaties.



Summary

- ***Commission on Reinsurance Accepted:*** The reinsurer generally allows commission to reinsured on apart of business ceded. This is treated as expense of the company.
- ***Commission on Reinsurance ceded:*** Reinsurance generally gets commission for giving the business under reinsurance contract. It appears as an income in revenue account.
- ***Coinsurance:*** when a large risk is offered to an insurance company, then that insurance company retains certain percentage of sum insured and contracts other insurance company to underwriter the balance of risk. In this way, all the companies jointly bear the risk. One is called as the leader who issues the policy and acts on behalf of others.
- ***Reserve for unexpired Risk:***

  For Marine Business = 100% of net premium income

  For others = 50% of net premium income

Unit – 3 : Financial Statements of Insurance Companies

Learning Objectives

After studying this unit, you will be able to:

Prepare financial statements of insurance companies carrying on life insurance business.

Prepare financial statements of insurance companies carrying on general insurance

Understand the requirements of IRDA Regulations, 2002.

3.1 Introduction

Insurance Regulatory and Development Authority, after consultation with the Insurance Advisory Committee, in exercise of the powers conferred by section 114A of the Insurance Act, 1938 (4 of 1938) published the Insurance Regulatory and Development Authority (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations 2000 in the official Gazettee on 14th August, 2000. Recently that Guidelines are revised and a new set of guidelines have been issued vide notification dated 30th March, 2002 [www.irdaindia.org]. As per the IRDA Guidelines, an insurer carrying on life insurance business shall comply with the requirements given in Schedule A, an insurer carrying on general insurance business shall comply with the requirements given in Schedule B and the report of the auditors shall be in conformity with the requirements of Schedule C.

3.2 Structure of Schedules A and B

The following table depicts the structure of schedules A and B given under IRDA regulations:

Schedule A for Life Insurance Business	**Schedule B for General Insurance Business**
Part I: Accounting Principles for preparation of financial statement Part II: Disclosures forming part of Financial Statements Part III: General Instructions for preparation of financial statements Part IV: Contents of Management Report Part V: Preparation of Financial statements Form A-RA: Revenue Account Form A-PL: Profit and Loss Account Form A-BS: Balance sheet and 15 Schedules forming part of financial statements	Part I: Accounting Principles for preparation of financial statements Part II: Disclosures forming part of Financial Statement Part III: General Instructions for preparation of financial statements. Part IV: Contents of Management Report Part V: Preparation of financial statements. Form B-RA: Revenue Account Form B-PL: Profit and Loss Account Form B-BS: Balance Sheet and 15 Schedules forming part of financial statements

3.3 Financial Statements

Life Insurance Business

The insurance company carrying life insurance business is required to prepare Balance sheet Form A – BS, Revenue account [Policy holders' account] Form A- RA, Profit and loss account Form A-PL. These forms have been given in the IRDA Regulations, 2002.

No form has been specified for cash flow statement.

General Insurance Business

The insurance company carrying on general insurance business is required to prepare Balance Sheet Form B – BS, Revenue account [Policy holders' account] Form B- RA, Profit and loss account Form B-PL. These forms have been given in the IRDA Regulations, 2002.

No form has been specified for cash flow statement.

3.4 IRDA Regulations, 2002

Some of the contents of the IRDA Regulations, 2002 have been given below:

1. Preparation of financial statements, management report and auditor's report

(1) An insurer carrying on life insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule A.

(2) An insurer carrying on general insurance business, after the commencement of these Regulations, shall comply with the requirements of Schedule B:

Provided that this sub-regulation shall apply, *mutatis mutandis,* to reinsurers until separate regulations are made for them.

(3) The report of the auditors on the financial statements of every insurer and reinsurer shall be in conformity with the requirements of Schedule C, or as near thereto as the circumstances permit.

Note: For details regarding Schedule A and Schedule B refer Annexure I and Annexure II respectively, given at the end of this Chapter.

SCHEDULE C *(See Regulation 3):* AUDITOR'S REPORT

The auditors shall express their opinion on

- whether the balance sheet gives a true and fair view of the insurer's affairs as at the end of the financial year/period;
- whether the revenue account gives a true and fair view of the surplus or the deficit for the financial year/period;
- whether the profit and loss account gives a true and fair view of the profit or loss for the financial year/period; and

- whether the receipts and payments account gives a true and fair view of the receipts and payments for the financial year/period.

The auditor should also comply with other provisions stated in the IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002.

3.5 Preparation of Financial Statements

After studying IRDA Regulations, let us work out few illustrations which will help you in understanding the procedure for preparation of financial statements of insurance companies.

Students are required to go through the formats of Revenue Account, Profit and Loss Account, Balance Sheet and its Schedules as prescribed in Part V of Schedule A for Life Insurance business given in Annexure I for better understanding of the illustration given here under.

Illustration 1

From the following balance as at 31st March, 2012 in the books of the National Life Assurance Co. Ltd., prepare Profit and Loss Account and Balance Sheet.

	₹ '000		₹ '000
Life Assurance Fund on 1st		Agents' Balances (Dr.)	18,000
April, 2011	34,00,000	Advances to ceding companies	47,000
Annuities paid (in India 72,500)	81,750	Due from Re-insurers	38,500
General Reserve	2,25,000	Due to Re-insurers	47,500
Deposit with the Reserve Bank		Sundry Creditors	1,800
—Government Securities	2,10,000	Premiums : First year	5,90,000
Indian Government Securities	10,90,000	Renewal	1,20,000
Foreign Government Securities	75,000	Reinsurance accepted	50,000
Loan on Company's Policies	2,10,000	Reinsurance ceded	70,000
Leasehold Buildings	63,300	Interim Bonus to Policy-holders	22,500
Securities on which interest is		Commission –	
guaranteed by the Government	4,50,000	Direct : First year	40,500
Stocks of Shares of companies		Renewal	2,000
incorporated in India	14,50,000	Reinsurance accepted	12,000
Share Capital (20,000 shares @	20,00,000	Reinsurance ceded	4,000
₹ 100 each)		Claims	
Mortgages in India	14,32,500	By Death (in India 1,30,000)	2,00,000
Cash with Bankers on		By Maturity (in India 1,40,000)	2,20,000
Current Account	40,500	Bank Loan	21,750
Cash with Bankers on		Salaries	30,400
Deposit (short-term) Account	20,000	Auditors' Fees	5,400
Cash in hand	7,000	Law Charges	3,400

State Government Securities	*7,25,000*	*Rent paid*	*3,600*
Furniture and Fixtures	*39,000*	*Other Expenses of Management*	*750*
Outstanding Premiums	*66,000*	*Travelling Expenses*	*1,950*
		Interest and Rents Received (Gross)	*2,16,000*

Transfer the surplus amount if any to Life Fund for the year ended 31st March, 2012. 5% dividend is also proposed on share capital.

Solution

In the books of National Life Assurance Co. Ltd.
Revenue Account for the year ended 31st March, 2012

Policyholders' Account (Technical Account)

Particulars	Schedule		Current Year	Previous Year
		(₹'000)	(₹'000)	(₹'000)
Premiums earned – net				
(a) Premium	1	7,10,000		
(b) Reinsurance ceded		(70,000)		
(c) Reinsurance accepted		50,000	6,90,000	
Income from Investments				
(a) Interest, Dividends & Rent – Gross			2,16,000	
(b) Profit on sale/redemption of investments				
(c) (Loss on sale/redemption of investments)				
(d) Transfer/Gain on revaluation change in fair value				
Other Income (to be specified)				
Total (A)			9,06,000	
Commission	2	50,500		
Operating Expenses related to Insurance Business	3	45,500		
Other Expenses (to be specified)		—		
Provisions (other than taxation)				
(a) For diminution in the value of investments (Net)				
(b) Others (to be specified)				
Total (B)			96,000	
Benefits Paid (Net)	4	5,01,750		

Interim Bonuses Paid		22,500		
Change in valuation of liability against life policies in force				
(a) Gross				
(b) (Amount ceded in Reinsurance)				
(c) Amount accepted in Reinsurance				
Total (C)			5,24,250	
Surplus [(A) – (B) – (C)]			2,85,750	
Appropriations				
Transfer to Shareholders' Account			2,85,750	
Transfer to Other Reserves (to be specified)			-	
Transfer to Funds for Future Appropriations			-	
Total (D)			2,85,750	

Form A-PL

Profit & Loss Account for the year ended 31st March, 2012

Shareholders' Account (Non-technical Account)

Particulars	**Schedule**	**Current Year**	**Previous Year**
		(₹'000)	*(₹'000)*
Balance brought forward from/transferred to the Policyholders Account (Technical Account)		2,85,750	
Income From Investments			
(a) Interest, Dividends & Rent – Gross			
(b) Profit on sale/redemption of investments			
(c) (Loss on sale/redemption on investments)			
Other Income (To be specified)			
Total (A)			
Expense other than those directly related to the insurance business			
Provisions (Other than taxation)			
(a) For diminution in the value of investments (Net)			
(b) Other (to be specified)			
Total (B)			
Profit/(Loss) before tax			
Provision for Taxation			

Profit/(Loss) after tax			
Appropriations			
(a) Brought forward Reserve Surplus from the Balance Sheet			
(b) Interim dividends paid during the year			
(c) Proposed final dividend		1,00,000	
(d) Dividend distribution on tax			
(e) Transfer to reserves/other accounts (to be specified)			
Profit carried forward to the Balance Sheet		1,85,750	

Notes :

(a) In case of premiums, less reinsurance in respect of any segment of insurance business of total Premium earned, the same shall be disclosed separately.

(b) Premium income received from business concluded in and outside India shall be separately disclosed.

(c) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e., before deducting commissions) under the head reinsurance premiums.

(d) Claims incurred shall comprise claims paid, settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(e) Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.

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

(g) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(h) Interest, dividends and rentals receivable in connection with the investment should be stated as gross amount, the amount of income tax deducted at source being included under advance taxes paid and taxes deducted at source."

(i) Income from rent shall include only the realised rent. It shall not include any notional rent.

Balance Sheet as at 31st March, 2012

	Schedule	Current Year	Previous Year
		(₹'000)	*(₹'000)*
Sources of Funds			
Shareholders' Funds			
Share Capital	5	20,00,000	
Reserves and Surplus	6	38,10,750	
Credit/[Debit] Fair value change account			
Sub-Total			

Borrowings	7	69,250	
Policyholders' Funds			
Credit/[Debit] Fair value change account			
Policy Liabilities			
Insurance reserves			
Provision for linked liabilities			
Sub-Total			
Funds for future appropriations			
Total		58,80,000	
Application of Funds			
Investments	8	40,00,000	
Shareholders'			
Policyholders'			
Assets held to cover linked liabilities			
Loans	9	16,42,500	
Fixed Assets	10	1,02,300	
Current Assets			
Cash and Bank Balances	11	67,500	
Advances and Other Assets	12	1,69,500	
Sub-Total (A)		2,37,000	
Current Liabilities	13	1,800	
Provisions	14	1,00,000	
Sub-Total (B)		1,01,800	
Net Current Assets (C) = (A – B)		1,35,200	
Miscellaneous expenditure		—	
(to the extent not written off or adjusted)			
Debit Balance in profit & Loss Account			
(Shareholders' Account)			
Total [Sch.8,9,10 & (C)]		58,80,000	

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE–1: PREMIUM

	Particulars	Current Year	Previous Year
		(₹'000)	*(₹'000)*
1.	First year premiums	5,90,000	
2.	Renewal premiums	1,20,000	
3.	Single premiums	____	
	Total premiums	7,10,000	
	Premiums Income from business written :		
1.	In India		
2.	Outside India		
	Total premiums (Net)		

SCHEDULE–2: COMMISSION EXPENSES

Particulars	Current Year	Previous Year
	(₹'000)	*(₹'000)*
Commission paid		
Direct – First year premium	40,500	
– Renewal premiums	2,000	
– Single premiums		
Add : Commission on Re-insurance Accepted	12,000	
Less : Commission on Re-insurance Ceded	(4,000)	
Net Commission	50,500	

Notes :

The profit/commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE–3: OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

	Particulars	Current Year	Previous Year
		(₹'000)	*(₹'000)*
1.	Employees' remuneration & welfare benefits	30,400	
2.	Travel, conveyance and vehicle running expenses	1,950	
3.	Rents, rates & taxes	3,600	
4.	Repairs		
5.	Printing & stationery		
6.	Communication expenses		
7.	Legal & professional charges	3,400	

8.	Medical fees		
9.	Auditors' fees, expenses etc.	5,400	
	(a) as auditor		
	(b) as adviser or in any other capacity, in respect of		
	(i) Taxation matters		
	(ii) Insurance matters		
	(iii) Managements services, and		
	(c) in any other capacity		
10.	Advertisement and publicity		
11.	Interest & Bank Charges		
12.	Others (to be specified)	750	
13.	Depreciation		
	Total	45,500	

SCHEDULE–4: BENEFITS PAID [NET]

	Particulars	Current Year	Previous Year
		(₹'000)	*(₹'000)*
1.	Insurance Claims		
	(a) Claims by Death,	2,00,000	
	(b) Claims by Maturity,	2,20,000	
	(c) Annuities/Pensions in payment,	81,750	
	(d) Other benefits, specify		
2.	(Amount ceded in reinsurance) :		
	(a) Claims by Death,		
	(b) Claims by Maturity,		
	(c) Annuities/Pensions in payment,		
	(d) Other benefits, specify		
3.	Amount accepted in reinsurance :		
	(a) Claims by Death,		
	(b) Claims by Maturity,		
	(c) Annuities/Pensions in payment,		
	(d) Other benefits, specify		
	Total	5,01,750	
	Benefits paid to claimants :		
1.	In India (72,500 + 1,30,000 + 1,40,000)	3,42,500	
2.	Outside India	1,59,250	
	Total Benefits paid (Net)	5,01,750	

SCHEDULE–5: SHARE CAPITAL

	Particulars	Current Year	Previous Year
		(₹'000)	*(₹'000)*
1.	Authorised Capital		
	Equity Shares of ₹ ...... each		
2.	Issued Capital		
	Equity Shares of ₹ ...... each		
3.	Subscribed Capital		
	Equity Shares of ₹ ...... each	20,00,000	
4.	Called-up Capital		
	Equity Shares of ₹ ...... each		
5.	*Less :* Calls unpaid		
	Add : Share forfeited (Amount Originally paid up)		
	Less : Par value of Equity Shares bought back		
	Less : Preliminary Expenses		
	Expenses including commission or brokerage on Underwriting or subscription of shares		
	Total	20,00,000	

Notes :

(a) Particulars of the different classes of capital should be separated stated.

(b) The amount capitalised on account of issue of bonus shares should be disclosed.

(c) In case any part of the capital is held by a holding company, the same should be separately disclosed.

SCHEDULE–5A: PATTERN OF SHAREHOLDING

[As certified by the Management]

	Particulars	Current Year		Previous Year	
		Number of Shares	% of Holding	Number of Shares	% of Holding
	Promoters				
	• Indian				
	• Foreign				
	Others				
	Total				

SCHEDULE–6: RESERVES AND SURPLUS

	Particulars	Current Year *(₹'000)*	Previous Year *(₹'000)*
1.	Capital Reserve		

2.	Capital Redemption Reserve		
3.	Share Premium		
4.	Revaluation Reserve		
5.	General Reserves	2,25,000	
	Less : Debit balance in Profit and Loss Account, if any		
	Less Amount utilized for Buy-back		
6.	Catastrophe Reserve		
7.	Other Reserves (to be specified) Life Fund		
	Opening balance 34,00,000		
	Transfer during the year 1,87,750	35,85,750	
8.	Balance of profit in Profit and Loss Account		
	Total	**38,10,750**	

Notes :

Additions to and deductions from the reserves should be disclosed under each of the specified heads.

SCHEDULE–7: BORROWINGS

	Particulars	Current Year (₹'000)	Previous Year (₹'000)
1.	Debentures/Bonds		
2.	Fixed Deposits		
3.	Banks	21,750	
4.	Financial Institutions		
5.	Other entities carrying on insurance business	47,500	
	Total	69,250	

Notes :

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately.

The classification of investments as desired by schedule 8 and 8A of the format can't be done due to non-availability, of formation of shareholders' and policyholders' investments. Therefore, investments are shown as follows (included as total figure in the Balance Sheet)

SCHEDULE–8: INVESTMENTS

Particulars	Current Year	Previous Year
	(₹'000)	*(₹'000)*
Deposit with the RBI	2,10,000	
Indian Government Securities	10,90,000	
State Government Securities	7,25,000	
Foreign Government Securities	75,000	
Securities guaranteed by the Government	4,50,000	
Stock and shares of companies incorporated in India	14,50,000	
	40,00,000	

SCHEDULE–9: LOANS

Particulars	Current Year	Previous Year
	(₹'000)	*(₹'000)*
1. Security-wise classification		
Secured		
(a) On mortgage of property		
(aa) In India	14,32,500	
(bb) Outside India		
(b) On shares, Bonds, Govt. Securities, etc.		
(c) Others (to be specified)		
Unsecured		
(a) Loans against policies	2,10,000	
(b) Others (to be specified)		
Total	16,42,500	
2. Borrower-wise classification		
(a) Central and State Governments		
(b) Banks and Financial Institutions		
(c) Subsidiaries		
(d) Companies		
(e) Loans against policies		
(f) Others (to be specified)		
Total		
3. Performance-wise classification		
(a) Loans classified as standard		
(aa) In India		
(bb) Outside India		
Non-standard loans less provisions		
(aa) In India		
(bb) Outside India		
Total		

4. Maturity-wise classification (a) Short Term (b) Long Term **Total**		

Notes :

(a) Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.

(b) Provisions against non-performing loans shall be shown separately.

(c) The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of his schedule, means loans secured wholly or partly against on asset of the company.

(d) Loans considered doubtful and the amount of provision created against such loans shall be disclosed.

SCHEDULE–10: FIXED ASSETS

(₹ '000)

Particulars	Cost/Gross Block	Depreciation	Net Block
Goodwill			
Intangibles (specify)			
Land-Freehold			
Leasehold Property			63,300
Buildings			
Furniture & Fittings			39,000
Information Technology			
Equipment			
Vehicles			
Office Equipment			
Others (Specify nature)			
Total			1,02,300

Notes :Assets included in land, property and building above exclude Investment Properties as defined in note (e) to Schedule 8.

SCHEDULE–11: CASH AND BANK BALANCES

Particulars	Current Year	Previous Year
	(₹ '000)	*(₹ '000)*
1. Cash (including cheques, drafts and stamps)	7,000	
2. Bank Balances		
(a) Deposit Accounts		
(aa) Short-term (due within 12 months of the		

	date of Balance Sheet)	20,000	
	(bb) Others		
	(b) Current Accounts	40,500	
	(c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		
	(b) With other Institutions		
4.	Others (to be specified)		
	Total	67,500	

Balances with non-scheduled banks included in 2 and 3 above

SCHEDULE – 12

ADVANCES AND OTHER ASSETS

	Particulars	Current Year	Previous Year
		(₹'000)	(₹'000)
	ADVANCES		
1.	Reserve deposits with ceding companies	47,000	
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	TOTAL (A)	47,000	
	OTHER ASSETS		
1.	Income accrued on investments		
2.	Outstanding Premiums	66,000	
3.	Agents' Balances	18,000	
4.	Foreign Agencies Balances		
5.	Due from other entities carrying on insurance business (including reinsures)	38,500	
6.	Due from subsidiaries/ holding		
7.	Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938]		
8.	Others (to be specified)		
	TOTAL (B)	1,22,500	
	TOTAL (A+B)	1,69,500	

SCHEDULE – 13

CURRENT LIABILITIES

	Particulars	Current Year	Previous Year
		(₹'000)	*(₹'000)*
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated Premium		
6.	Sundry creditors	1,800	
7.	Due to subsidiaries/ holding company		
8.	Claims Outstanding		
9.	Due to Officers/ Directors		
10.	Others (to be specified)		
	TOTAL	1,800	

SCHEDULE – 14

PROVISIONS

	Particulars	Current Year	Previous Year
		(₹'000)	(₹'000)
1	Reserve for Unexpired Risk		
2	For taxation (less advance tax paid and taxes deducted at source)		
3	For proposed dividends	1,00,000	
4	For dividend distribution tax		
5	Others (to be specified)		
	TOTAL	1,00,000	

Students are required to go through the formats of Revenue Account, Profit and Loss Account, Balance Sheet and its Schedules as prescribed in Part V of Schedule B for General Insurance business given in Annexure II for better understanding of illustrations given here under.

Illustration 2

Prepare Revenue Account in proper form for the year ended 31st March, 2012, from the following particulars related to Goma General Insurance Co. for the year 2011 – 2012:

	Related to Direct business (₹)	Related to Reinsurance business (₹)
Premiums:		
Amount received	30,00,000	2,40,000
Receivable at the beginning	1,80,000	24,000
Receivable at the end	2,40,000	36,000
Amount paid	--	3,60,000
Payable at the beginning	--	30,000
Payable at the end	--	42,000
Claims:		
Amount paid	18,00,000	1,80,000
Payable at the beginning	60,000	12,000
Payable at the end	1,20,000	18,000
Amount recovered	_	1,20,000
Receivable at the beginning	_	18,000
Receivable at the end	_	12,000
Commission:		
Amount paid	72,000	10,800
Amount received	--	14,400

Additional information:

(i)	*Interest, dividend and rent received*	*30,000*
	Income-tax in respect of above	*6,000*
(ii)	*Management expenses including ₹ 12,000 related to legal expenses regarding claims*	*1,32,000*

Provision for income tax existing at the beginning of the year was ₹ 1,95,000, the income-tax actually paid during the year ₹ 1,68,000 and the provision necessary at the year end ₹ 2,07,000.

The net premium income of the company during the year 2010 – 2011 was ₹ 24,00,000 on which reserve for unexpired risk @ 50% and additional reserve @ 7 ½ % was created. This year, the balance to be carried forward is 50% of net premium on reserve for unexpired risk and 5% on additional reserve.

Solution

FORM B – RA

Name of the Insurer : Goma General Insurance Company

Registration no. and date of registration with IRDA : ………………..

Revenue Account for the year ended 31.3.2012

	Particulars	Schedule	Amount (₹)
1.	Premium earned (Net)	1	27,03,000
2.	Profit/Loss on sales/Redemption of investment	-	-
3.	Other	-	-
4.	Interest, dividend & rent (Gross)	-	30,000
	Total (A)		27,33,000
1.	Claims incurred (Net)	2	19,44,000
2.	Commission	3	68,400
3.	Operating expenses related to insurance business	4	1,20,000
	Total (B)		21,32,400
	Operating profit/Loss from insurance business (C) = (A-B)		6,00,600

Appropriation:

Transfer to Shareholders account	-
Transfer to Catastrophe Reserve	-
Transfer to other reserves	-
Total (D)	-

Schedule – 1 Premium Earned (Net)	
Particulars	₹
Premium received from direct business (W.N.1)	30,60,000
Add: Premium on reinsurance accepted ₹ (2,40,000 + 36,000 – 24,000)	2,52,000
	33,12,000
Less: Premium on reinsurance ceded ₹ (3,60,000 + 42,000 – 30,000)	(3,72,000)
Net Premium	29,40,000
Adjustment for change in reserve for unexpired risk (W.N.2)	(2,37,000)
Total premium earned (Net)	27,03,000

Schedule – 2 Claims Incurred (Net)

Particulars	₹
Claims paid (Direct)	18,00,000
Add: Legal expenses regarding claims	12,000
	18,12,000
Add: Reinsurance Accepted	1,80,000
	19,92,000
Less: Reinsurance ceded ₹ (1,20,000 + 12,000 –18,000)	(1,14,000)
	18,78,000
Add: Claims outstanding at the end ₹ (1,20,000 + 18,000)	1,38,000
Less: Claims outstanding at the beginning ₹ (60,000 + 12,000)	(72,000)
Total claim incurred	19,44,000

Schedule –3 Commission

Particulars	₹
Commission paid Direct	72,000
Add: Re-insurance accepted	10,800
	82,800
Less: Re-insurance ceded	(14,400)
Net commission	68,400

Schedule – 4 Operating Expenses related to Insurance Business

Particulars	₹
Expenses of management ₹ (1,32,000 – 12,000)	1,20,000

Working Notes:

1. Calculation of premium received from direct business

Premium on direct business	30,00,000
Add: Premium outstanding at the end	2,40,000
	32,40,000
Less: Premium outstanding at the beginning	(1,80,000)
	30,60,000

2. Computation of change in reserve for unexpired risk

	₹
Reserve for unexpired risk for the year 2011-12 (29,40,000 x 50%)	14,70,000
Add: Additional reserve for unexpired risk for the year 2011-12 (29,40,000 x 5%)	1,47,000
	16,17,000
Less: Reserve for unexpired risk for the year 2010-11 (24,00,000 x 50%)	(12,00,000)
Additional reserve for unexpired risk for the year (24,00,000 x 7.5%)	(1,80,000)
	2,37,000

Illustration 3

Metro General Insurance Company submits the following information for the year ended 31st March, 2014:

Particulars	*Director Business (₹)*	*Reinsurance (₹)*
Premium received	*75,25,000*	*8,25,000*
Premium paid	*-*	*4,90,000*
Claim paid during the year	*49,70,000*	*5,10,000*
Claim payable:		
1st April, 2013	*6,85,000*	*95,000*
31st March, 2014	*7,38,000*	*70,000*
Claims received	*-*	*3,95,000*
Claims receivable:		
1st April, 2013	*-*	*75,000*
31st March, 2014	*-*	*1,25,000*
Expenses of Management	*2,90,000*	*-*
Commission:		
On Insurance accepted	*1,60,000*	*15,000*
On Insurance ceded	*-*	*18,000*

The following additional information are also available:

(1) Expenses of Management include ₹ 45,000 Surveyor's fees and ₹ 55,000 Legal expenses for settlement of claims.

(2) *Reserve for unexpired risk is to be maintained @ 40%. The balance of Reserve for unexpired risk as on 01.04.2013 was ₹ 28,40,000.*

You are required to make the Revenue Account for the year ended 31st March, 2014.

Answer

Form B-RA (Prescribed by IRDA)

Metro General Insurance Company

Revenue Account for the year ended 31st March, 2014

Particulars	*Schedule*	*Amount (₹)*
Premium earned (Net)	1	75,56,000
Interest, dividend and rent		-
Other Income		
Total (A)		75,56,000
Claims incurred (Net)	2	51,63,000
Commission	3	1,57,000
Operating expenses related to insurance business	4	1,90,000
Bad Debts		-
Total (B)		55,10,000
Operating profit from insurance business (A-B)		20,46,000

Schedules forming part of Revenue Account

Schedule 1: Premium Earned (Net)

Particulars	*Amount (₹)*
Premium from direct business	75,25,000
Add: Premium on reinsurance accepted	8,25,000
Less: Premium on reinsurance ceded	(4,90,000)
Net Premium	78,60,000
Adjustment for change in Reserve for unexpired risk (W.N.2)	(3,04,000)
Total Premium earned (net)	75,56,000

Schedule 2: Claims Incurred (Net)

Particulars	*Amount (₹)*
Claims paid direct business (W.N.1)	51,23,000
Add: Re-insurance accepted (W.N.1)	4,85,000
Less: Re-insurance ceded (W.N.1)	(4,45,000)
Net Claims paid	51,63,000

Schedule 3: Commission

Particulars	*Amount (₹)*
Commission paid on direct business	1,60,000
Add: Commission on reinsurance accepted	15,000
Less: Commission on reinsurance ceded	(18,000)
	1,57,000

Schedule 4: Operating Expenses related to Insurance Business

Particulars	*Amount (₹)*
Expenses of management (2,90,000 – 45,000 – 55,000)	1,90,000
	1,90,000

Working Notes:

1. **Claims incurred**

Particulars	*Direct Business (₹)*	*Re-insurance accepted (₹)*	*Re-insurance Ceded (₹*
Paid / received	49,70,000	5,10,000	3,95,000
Add: Outstanding at the end of the year	7,38,000	70,000	1,25,000
Add: Expenses in connection with settlement of claims (45,000 + 55,000)	1,00,000		
Less: Outstanding at the beginning of the year	(6,85,000)	(95,000)	(75,000)
	51,23,000	4,85,000	4,45,000

2. **Change in Reserve for unexpired risk**

Particulars	*Amount (₹)*
Opening Reserve as on 31st March, 2013	28,40,000
Less: Closing Reserve as on 31st March, 2014 (₹78,60,000 x 40%)	(31,44,000)
	3,04,000

Illustration 4

The following are the Balances of Hercules Insurance Co. Ltd. as on 31st March, 2013 :

	(₹ in '000)
Capital	*320,00*
Balances of Funds as on 1.4.2012	
Fire Insurance	*800,00*
Marine Insurance	*950,00*
Miscellaneous Insurance	*218,65*

Unclaimed Dividends		*8,50*
Amount Due to Other Insurance Companies		*34,50*
Sundry Creditors		*72,50*
Deposit and Suspense Account (Cr.)		*22,80*
Profit and Loss Account (Cr.)		*80,40*
Agents Balances (Dr.)		*135,00*
Interest accrued but not due (Dr.)		*22,50*
Due from other Insurance Companies		*64,50*
Cash in Hand		*3,50*
Balance in Current Account with Bank		*74,80*
Furniture and Fixtures WDV (cost 100,00)		*58,00*
Stationery Stock		*1,40*
Expenses of Management		
Fire Insurance	*280,00*	
Marine Insurance	*168,00*	
Miscellaneous Insurance	*40,00*	
Others	*30,00*	*518,00*
Outstanding premium		*82,00*
Donation Paid (No 80G Benefit)		*10,00*
Transfer Fees		*1,00*
Reserve for Bad Debts		*11,70*
Income Tax Paid		*120,00*
Mortgage Loan (Dr.)		*975,00*
Sundry Debtors		*25,00*
Government Securities Deposited with RBI		*37,00*
Government Securities		*1020,00*
Debentures		*465,50*
Equity Shares of Joint Stock Companies		*225,00*
Claims Less Re-insurance		
Fire	*450,00*	
Marine	*358,90*	
Miscellaneous	*68,00*	*876,90*
Premium Less Re-insurance		
Fire	*1762,50*	
Marine	*1022,50*	

Miscellaneous	*262,25*	*3047,25*
Interest and Dividends Received on Investments (Net)		*4680*
Tax Deducted at Source		*11,70*
Commission		
Fire	*500,00*	
Marine	*350,00*	
Miscellaneous	*80,00*	*930,00*

You are required to make the following provisions :

Depreciation on Furniture—10% of Original Cost	
Depreciation on investments of Joint Stock Companies Shares	*10,00*
Transfer to General Reserve	*10,00*

Outstanding claims as on 31.3.2013

Fire	*200,00*
Marine	*50,00*
Miscellaneous	*32,50*

Provision for tax @ 50%. Proposed dividends @20%. Provision for the unexpired risks is to be made as follows:

(a) On Marine Policies 100% Premium less reinsurance.

(b) On Other Policies 50% Premium less reinsurance.

You are required to prepare the revenue and profit and loss account for the year ended 31.3.2013 of the company.

Solution

Form B – RA (Prescribed by IRDA)
Hercules Insurance Co. Ltd.
Revenue Account for the year ended 31st March, 2013
Fire and Marine and Misc Insurance Businesses

	Schedule	Fire Current Year	Marine Current Year	Misc. Current Year
		₹ '000	₹ '000	₹ '000
Premiums earned (net)	1	1681,25	950,00	349,77
Interest, Dividends and Rent – Gross		—	—	—
Total (A)		1681,25	950,00	349,77
Claims incurred (net)	2	650,00	408,90	100,50

Commission	3	500,00	350,00	80,00
Operating expenses related to Insurance business	4	280,00	168,00	40,00
Total (B)		1430,00	926,90	220,50
Profit from Fire/Marine Insurance business (A–B)		251,25	23,10	129,27

Schedules forming part of Revenue Account

Schedule –1

Premiums earned (net)	**Fire Current Year**	**Marine Current Year**	**Misc. Current Year**
	₹'000	₹'000	₹'000
Premiums *Less* reinsurance (net)	1762,50	1022,50	262,25
Change in provision for unexpired risk	(-)81,25	(-) 72,50	87,52
Premiums earned (net)	1681, 25	950,00	349,77
Schedule – 2			
Claims incurred (net)	650,00	408,90	100,50
Schedule – 3			
Commission paid	500,00	350,00	80,00
Schedule – 4			
Operating expenses related to insurance business			
Expenses of Management	280,00	168,00	40,00

Form B-PL
Hercules Insurance Co. Ltd.
Profit and Loss Account for the year 31st March, 2013

Particulars	**Schedule**	**Current Year**	**Previous Year**
		₹' (000)	*₹' (000)*
Operating Profit/(Loss)			
(a) Fire Insurance		251,25	
(b) Marine Insurance		23,10	
(c) Miscellaneous		129,27	
Income From Investments			
(a) Interest, Dividend & Rent–Gross		58,50	
Other Income			
Transfer Fees		1,00	

Total (A)		463,12	
Provisions (Other than taxation)			
Depreciation of Furniture		10,00	
Depreciation of Investments		10,00	
Other Expenses –			
Expenses of Management		30,00	
Donation		10,00	
Total (B)		60,00	
Profit Before Tax (A-B)		403,12	
Provision for Taxation		206,56	
Profit After Tax		196,56	
Profit			
(a) Interim dividends paid during the year		—	
(b) Proposed final dividend		64,00	
(c) Dividend distribution tax		—	
(d) Transfer to General Reserves or Other Accounts (to be specified)		10,00	
		12,256	
Balance of profit/loss brought forward from last year		80,40	
Balance carried forward to Balance Sheet		202,96	

Working Notes:

1. Reserve for unexpired risk 50% of net premium for fire and miscellaneous and 100% of net premium for marine.

2. Provision for Taxation

	₹
Net Profit before tax	403,12
Add : Donation	10,00
Taxable Profit	413,12

Tax 50%

Illustration 5

The following figures have been extracted from the books of New India Insurance Company Ltd. in respect of their Marine Business for 2011-2012: *(₹ in lakhs)*

Direct Business Income received	*50.00*	*Commission paid on Direct Business*	*5.00*
Reserve for unexpired risks as on 1.4.2011	*60.00*	*Expenses of Management*	*5.00*
Claims outstanding as on 1.4.2011	*20.00*	*Income tax deducted at*	*3.00*

(net)		*source*	
Bad Debts	*10.00*	*Profit and Loss Account: (Cr.) balance as on 1.4.2011*	*10.00*
Income from investment and dividends (gross)	*10.00*	*Other expenses*	*1.25*
Rent received from properties	*5.00*	*Reinsurance premium receipts*	*5.00*
Investment in government securities as on 1.4.2011	*100.00*	*Outstanding claims as on 31.3.2012 (net)*	*30.00*
Investment in shares as on 1.4.2011	*20.00*	*Direct claims paid (gross)*	*25.00*
		Reinsurance claims paid	*4.00*

Prepare a Revenue Account and Profit and Loss Account for the year after taking into account the following further information:

(a) All direct risks are reinsured for 20% of the risk.

(b) Claim a Commission of 25% on reinsurance ceded.

(c) Provide 25% Commission on reinsurance accepted

(d) Market value of investments as on 31st March, 2012 is as follows:

(i) Government Securities ₹ 105 lakhs.

(ii) Shares ₹ 18 lakhs.

Adjust separately for each of these two categories of investments.

(e) Provide 65% for Income tax.

Solution

Form B - RA

Name of the Insurer: New India Insurance Company Ltd.
Registration No. and date of registration with the IRDA: ……………..

Revenue Account for the year ended 31st March, 2012

	Particulars	*Schedule*	*Current Year (₹ in Lakhs)*	*Previous Year (₹ in Lakhs)*
1.	Premium earned (net)	1	60.00	
2.	Profit/Loss on sale/redemption of investments		-	
3.	Others		-	
4.	Interest, Dividend & Rent-Gross (10+5)		15.00	
	Total (A)		75.00	

1.	Claims Incurred (Net)	2	34.00	
2.	Commission	3	3.75	
3.	Operating expenses related to insurance business	4	16.25	
	Total (B)		54.00	
	Operating Profit/(Loss) from Marine Business (C) = (A-B)		21.00	
	Appropriations			
	Transfer to Shareholder's Account		–	
	Transfer to Catastrophe Reserve		–	
	Transfer to other Reserves (to be specified)		–	
	Total (C)		21.00	

Form B – PL

Name of the Insurer: New India Insurance Company Ltd.
Registration No. and date of registration with the IRDA: ……………..

Profit & Loss Account
for the year ended 31st March, 2012

	Particulars	Schedule	Current Year (₹ In Lakhs)	Previous Year (₹ In Lakhs)
1.	Operating Profit from marine insurance		21.00	
2.	Income from investments		-	
3.	Other Income		-	
	Total (A)		21.00	
4.	Provision (other than taxation)			
	Diminution in the value of investment in shares 2.00			
	Less: increment in the value of investment in govt. securities (5.00)		(3.00)	
5.	Other expenses		-	
	Total (B)		(3.00)	
	Profit before tax A-B [i.e. 21 – (-3)]		24.00	
	Less: Provision for taxation		(13.65)	
	Total		10.35	

	Appropriations		Nil	
	Balance of profit/loss bought forward from last year		10.00	
	Balance carried forward to Balance Sheet		20.35	

Schedule 1

Premium Earned (Net)

Particulars	*Current Year (₹ in Lakhs)*	*Previous Year (₹ in Lakhs)*
Premium from direct business	50.00	
Add: Premium on re-insurance accepted	5.00	
	55.00	
Less: Premium on re-insurance ceded	(10.00)	
Net Premium	45.00	
Adjustment for change in reserve for unexpired risk [(opening) 60 – (Closing) 45]	15.00	
	60.00	

Schedule 2

Claims incurred (Net)

Particulars	*Current Year (₹ in Lakhs)*	*Previous Year (₹ in Lakhs)*
Claims paid		
Direct	25.00	
Add: Reinsurance accepted	4.00	
	29.00	
Less: Reinsurance ceded	(5.00)	
Net Claims paid	24.00	
Add: Claims outstanding at the end of the year	30.00	
	54.00	
Less: Claims outstanding at the beginning of the year	(20.00)	
Total claims incurred	34.00	

Schedule 3

Commission

Particulars	*Current Year (₹ in Lakhs)*	*Previous Year (₹ in Lakhs)*
Commission paid : Direct	5.00	
Add: Re-insurance accepted	1.25	
	6.25	
Less: Commission on reinsurance ceded	(2.50)	
Net Commission	3.75	

Schedule 4

Operating Expenses

Particulars	*Current Year (₹ in Lakhs)*	*Previous Year (₹ in Lakhs)*
Expenses of Management	5.00	
Bad Debts	10.00	
Other expenses	1.25	
	16.25	

Working Note:

Provision for income tax:	*₹ in lakhs*
Income (excluding revaluation)	18.00
Add: Tax deducted at source	3.00
	21.00
Provision @ 65% of ₹ 21.00 lakhs	13.65
Less: Tax deducted at source	(3.00)
	10.65

Illustration 6

From the following information prepare the Revenue Account of Anmol Fire Insurance Company Ltd. for the year ended 31st March, 2012:

1. Premium, Claims and Commission:

Particulars	On Direct Business	On Re-Insurance ceded	On Re-insurance accepted
	₹	₹	₹
(a) Total Premium	30,00,000	10,00,000	20,00,000

	In India	80%	80%	80%
(b)	Total Claims	6,00,000	2,00,000	4,00,000
	Outside India	20%	20%	20%
(c)	Commission	3,00,000	1,00,000	2,00,000

2. Expenses:

		₹
1.	Employees' remuneration and welfare benefits	2,31,000
2.	Managerial Remuneration	3,00,000
3.	Travel, conveyance and vehicle running expenses	59,000
4.	Rents, rates and taxes	30,000
5.	Repairs	20,000
6.	Printing and Stationery	10,000
7.	Communication expenses	5,000
8.	Legal and Professional charges	6,000
9.	Medical fees	7,000
10.	Auditor's fees, expenses etc.	8,000
11.	Advertisement and publicity	6,000
12.	Interest and Bank Charges	5,000
13.	Policy Stamps	3,000

3. Others:

	₹
Furniture and fixture (cost ₹ 1,00,000)	58,000
Rate of Depreciation on furniture – 10% an original cost	
Interest, Dividend and Rent Received	90,000
Income Tax deducted at source thereon	10,000
Profit and Sale of Motor Car	5,000
Double Income Tax Refund	15,000
Provision of Unexpired Risks (as on 1.4.2011)	10,00,000
Additional Provision for Risks (as on 1.4.2011)	1,00,000
Accounting Policy Regarding Additional Provision in Fire- 5% of net premium of the year	

Solution

Fire Insurance Revenue Account for the year ended 31st March, 2012

Particulars		Schedule	Current Year	Previous Year
			(₹ '000)	(₹ '000)
1.	Premium earned (Net)	1	29,00	
2.	Other Income:			
	(a) Profit on sale of Motor Car		5	
	(b) Double Income Tax Refund		15	
3.	Interest, Dividend and Rent (Gross)		100	
	Total (A)		3020	
1.	Claims Incurred (Net)	2	800	
2.	Commission	3	400	
3.	Operating expenses related to Insurance Business	4	700	
	Total (B)		1900	
	Operating Profit from fire Insurance Business		1120	

SCHEDULE 1 Premium Earned (Net)

Particulars	Current Year	Previous Year
	(₹ '000)	(₹ '000)
Premium for Direct Business written	3,000	
Add: Premium on Re-insurance accepted	2,000	
Less: Premium on Re-insurance ceded	(1000)	
Change in Provision for Unexpired Risk	(1100)	
Net Premium	29,00	
Premium Income from business effected		
In India (80%)	2,320	
Outside India (20%)	580	
	29,00	

SCHEDULE 2 Claims Incurred (Net)

Particulars	*Current Year*	*Previous Year*
	(₹ '000)	*(₹ '000)*
Claim		
Direct	600	
Add: Re-insurance accepted	400	
Less: Re-insurance ceded	(200)	
Total claim incurred	800	
Claim paid to claimants:		
In India (80%)	640	
Outside India (20%)	160	
	800	

SCHEDULE 3 Commission

Particulars	*Current Year*	*Previous Year*
	(₹ '000)	*(₹ '000)*
Commission		
Direct	300	
Add: Commission on Re-insurance accepted	200	
Less: Commission on Re-insurance ceded	(100)	
Total	400	

SCHEDULE 4 Operating Expenses Related to Insurance Business

	Particulars	*Current Year*	*Previous Year*
		(₹ '000)	*(₹ '000)*
1.	Employees' remuneration and welfare benefits	231	
2.	Managerial Remuneration	300	
3.	Travel, conveyance and vehicle running expenses	59	
4.	Rents, rates and taxes	30	
5.	Repairs	20	
6.	Printing and Stationery	10	
7.	Communication expenses	5	
8.	Legal and Professional charges	6	

9.	Medical fees	7	
10	Auditors' fees, expenses etc.	8	
11.	Advertisement and publicity	6	
12.	Interest and Bank Charges	5	
13.	Policy Stamps	3	
14.	Depreciation (10% on ₹ 1,00,000)	10	
	Total	700	

Working Note: Change in Provision for Unexpired Risks

	Particulars		*(₹ 000)*
A.	Minimum Provision @ 50% of ₹ 40,00,000		2,000
B.	Add: Additional Provision @ 5% of ₹ 40,00,000		200
C.	Total		2,200
D.	Less: Opening Balance of Provision		
	(i) Minimum Provision	₹ 10,00,000	
	(ii) Additional Provision for Unexpired Risk	₹ 1,00,000	1,100
E.	Change in Provision for Unexpired Risk [C-D]		1,100

ANNEXURE I

SCHEDULE A for Life Insurance Business

PART I: Accounting principles for preparation of financial statements

1. Applicability of Accounting Standards---Every Balance Sheet, Revenue Account [Policyholders' Account], Receipts and Payments Account [Cash Flow statement] and Profit and Loss Account [Shareholders' Account] of an insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to insurers carrying on life insurance business, except that:

1. Accounting Standard 3 (AS 3) – Cash Flow Statements – Cash Flow Statement shall be prepared only under the Direct Method.
2. Accounting Standard 17 (AS 17) - Segment Reporting – shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

2. Premium – Premium shall be recognised as income when due. For linked business the due date for payment may be taken as the date when the associated units are created.

3. Acquisition Costs – Acquisition costs, if any, shall be expensed in the period in which they are incurred.

Acquisition costs are those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e., commencement of risk).

4. Claims Cost –The ultimate cost of claims shall comprise the policy benefit amount and specific claims settlement costs, wherever applicable.

5. Actuarial Valuation – Liability for Life Policies – The estimation of liability against life policies shall be determined by the appointed actuary of the insurer pursuant to his annual investigation of the life insurance business. Actuarial assumptions are to be disclosed by way of notes to the account.

The liability shall be so calculated that together with future premium payments and investment income, the insurer can meet all future claims (including bonus entitlements to policyholders) and expenses.

6. Procedure to determine value of investments. – An insurer shall determine the values of investments in the following manner:-

(a) **Real Estate – Investment Property –** The value of investment property shall be determined at historical cost, subject to revaluation at least once in every three years. The change in the carrying amount of the investment property shall be taken to Revaluation Reserve.

The insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

Gains/ losses arising due to changes in the carrying amount of real estate shall be taken to equity under 'Revaluation Reserve'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the carrying amount previously recognised in equity under the heading 'Revaluation Reserve' in respect of a particular property and being recycled to the relevant Revenue Account or Profit and Loss Account on sale of that property.

The bases for revaluation shall be disclosed in the notes to accounts. The Authority may issue directions specifying the amount to be released from the revaluation reserve for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the Authority's direction, no other amount shall be distributed to shareholders out of Revaluation Reserve Account.

An impairment loss shall be recognised as an expense in the Revenue/Profit and Loss Account immediately, unless the asset is carried at re-valued amount. Any impairment loss of a re-valued asset shall be treated as a revaluation decrease of that asset and if the impairment loss exceeds the corresponding revaluation reserve, such excess shall be recognised as an expense in the Revenue/Profit and Loss Account.

(b) **Debt Securities – Debt securities,** including government securities and redeemable preference shares, shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) **Equity Securities and Derivative Instruments that are traded in active markets –** Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value on the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price at the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies)/ derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogenous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealised gains/ losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account". The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading 'Fair Value Change Account' in respect of a particular security and being recycled to the relevant Revenue Account or Profit and Loss Account on actual sale of that listed security.

The Authority may issue directions specifying the amount to be released from the Fair Value Change Account for declaring bonus to the policyholders. For the removal of doubt, it is clarified that except for the amount that is released to policyholders as per the Authority's prescription, no other amount shall be distributed to shareholders out of Fair Value Change Account. Also, any debit balance in Fair Value Change Account shall be reduced from profit/free reserves while declaring dividends.

The insurer shall assess, on each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognised as an expense in Revenue/Profit and Loss Account to the extent of the difference between the re-measured fair value of the security/investment and its acquisition cost as reduced by any previous impairment loss recognised as expense in Revenue/Profit and Loss Account. Any reversal of impairment loss, earlier recognised in Revenue/Profit and Loss Account shall be recognised in Revenue/Profit and Loss Account.

(d) **Unlisted and other than actively traded Equity Securities and Derivative Instruments –** Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active markets shall be measured at historical cost. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as "thinly traded".

7. Loans – Loans shall be measured at historical cost subject to impairment provisions. The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India that apply to companies and financial institutions.

8. Linked Business – The accounting principles used for valuation of investments are to be consistent with principles enumerated above. A separate set of financial statements, for each segregated fund of the linked businesses, shall be annexed.

Segregated funds represent funds maintained in accounts to meet specific investment objectives of policyholders who bear the investment risk. Investment income/ gains and losses generally accrue directly to the policyholders. The assets of each account are segregated and are not subject to claims that arise out of any other business of the insurer.

9. Funds for Future Appropriation – The funds for future appropriation shall be presented separately.

The funds for future appropriation represent all funds, the allocation of which, either to the policyholders or to the shareholders, has not been determined by the end of the financial year.

PART II: Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:
   - (a) Partly-paid up investments
   - (b) Underwriting commitments outstanding
   - (c) Claims, other than those under policies, not acknowledged as debts
   - (d) Guarantees given by or on behalf of the company
   - (e) Statutory demands/liabilities in dispute, not provided for
   - (f) Reinsurance Obligations to the extent no provided for in accounts
   - (g) Others (to be specified).
2. Actuarial assumptions for valuation of liabilities for life policies in force.
3. Encumbrances to assets of the company in and outside India.
4. Commitments made and outstanding for Loans, Investments and Fixed Assets.

5. Basis of amortisation of debt securities.
6. Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.
7. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending;
   (b) Sales where payments are overdue.
8. Operating expenses relating to insurance business: basis of allocation of expenditure to various segments of business.
9. Computation of managerial remuneration.
10. Historical costs of those investments valued on fair value basis.
11. Basis of revaluation of investment property.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies, followed by the insurer, shall be stated in the manner required under Accounting Standard AS 1 issued by the ICAI.
2. Any departure from the accounting policies shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India;
2. Segregation into performing/ non performing investments for purpose of income recognition as per the directions, if any, issued by the Authority;
3. Assets to the extent required to be deposited under local laws or otherwise encumbered in or outside India;
4. Percentage of business sector-wise;
5. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority;
6. Bases of allocation of investments and income thereon between Policyholders' Account and Shareholders' Account;
7. Accounting Ratios as may be prescribed by the Authority.

PART III: General instructions for preparation of Financial Statements

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account, Profit and Loss Account and Receipts and Payments Account shall be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated at gross amount, the amount of income tax deducted at source should be included under 'advance taxes paid' and taxes deducted at source.

1\. (I) For the purposes of financial statements, unless the context otherwise requires -

(a) the expression ‘provision’ shall, subject to (II) below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;

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

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

(d) The expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(II) Where:

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

(b) any amount retained by way of providing for any known liability or loss, is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated as a reserve and not provision.

5\. The company shall make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.

6\. Extent of risk retained and re-insured shall be separately disclosed.

7\. Any debit balance of the Profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance, if any, shall be shown separately.

PART IV: Contents of Management Report

There shall be attached to the financial statements, a management report duly authenticated by the management.

PART V: Preparation of Financial Statements

1. An insurer shall prepare the Revenue Account [Policyholders' Account], Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form A-RA, Form A-PL and Form A-BS, as prescribed in this Part, or as near thereto as the circumstances permit.

   Provided that an insurer shall prepare Revenue Account and Balance Sheet for the under mentioned businesses separately and to that extent the application of AS 17 shall stand modified:-

   (a) Participating policies and Non-participating policies;

   (b) (i) Linked business [As defined in regulation 2 (i) of the IRDA (Registration of Indian Insurance Companies) Regulations , 2000]

   (ii) Non-Linked business separately for Ordinary Life, General Annuity, pensions and Health Insurance;

   Business within India and business outside India.

2. An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3 – "Cash Flow Statement" issued by the ICAI.

FORM A-RA

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

Policyholders' Account (Technical Account)

	Particulars	Schedule	Current Year (₹'000)	Previous Year (₹'000).
	Premiums earned – net			
	(a) Premium	1		
	(b) Reinsurance ceded			
	(c) Reinsurance accepted-			
	Income from Investments			
	(a) Interest, Dividends & Rent – Gross			
	(b) Profit on sale/redemption of investments			
	(c) (Loss on sale/ redemption of investments)			
	(d) Transfer/Gain on revaluation/change in fair value*			

	Other Income (to be specified)				
	TOTAL (A)				
	Commission	**2**			
	Operating Expenses related to Insurance Business	**3**			
	Provision for doubtful debts				
	Bad debts written off				
	Provision for Tax				
	Provisions (other than taxation)				
	(a) For diminution in the value of investments (Net)				
	(b) Others (to be specified)				
	TOTAL (B)				
	Benefits Paid (Net)	**4**			
	Interim Bonuses Paid				
	Change in valuation of liability in respect of life policies				
	(a) Gross**				
	(b) Amount ceded in Reinsurance				
	(c) Amount accepted in Reinsurance				
	TOTAL (C)				
	SURPLUS/ (DEFICIT) (D) =(A)-(B)-(C)				
	APPROPRIATIONS				
	Transfer to Shareholders' Account				
	Transfer to Other Reserves (to be specified)				
	Balance being Funds for Future Appropriations				
	TOTAL (D)				

Notes:

* *Represents the deemed realised gain as per norms specified by the Authority.*

** *represents Mathematical Reserves after allocation of bonus*

The total surplus shall be disclosed separately with the following details:

(a) Interim Bonuses Paid:

(b) Allocation of Bonus to policyholders:

(c) Surplus shown in the Revenue Account:

(d) Total Surplus: [(a)+(b)+(c)].

See Notes appended at the end of Form A-PL

FORM A-PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

PROFIT & LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

Shareholders' Account (Non-technical Account)

	Particulars	Schedule	Current Year	Previous Year
			(₹000)	*(₹000)*
	Amounts transferred from/to the Policyholders Account (Technical Account)			
	Income From Investments			
	(a) Interest, Dividends & Rent – Gross			
	(b) Profit on sale/redemption of investments			
	(c) (Loss on sale/ redemption of investments)			
	Other Income (To be specified)			
	TOTAL (A)			
	Expense other than those directly related to the insurance business			
	Bad debts written off			
	Provisions (Other than taxation)			
	(a) For diminution in the value of investments (Net)			
	(b) Provision for doubtful debts			
	(c) Others (to be specified)			
	TOTAL (B)			
	Profit/ (Loss) before tax			
	Provision for Taxation			
	Profit / (Loss) after tax			
	APPROPRIATIONS			
	(a) Balance at the beginning of the year			
	(b) Interim dividends paid during the year			

	(c) Proposed final dividend (d) Dividend distribution on tax (e) Transfer to reserves/ other accounts (to be specified) Profit carried ------------to the Balance Sheet			

Notes to Form A-RA and A-PL.

(a) Premium income received from business concluded in and outside India shall be separately disclosed.

(b) Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance premiums.

(c) Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end.

(d) Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹5,00,000 whichever is higher, shall be shown as a separate line item.

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

(f) Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.

(g) Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source".

(h) Income from rent shall include only the realised rent. It shall not include any notional rent.

FORM A-BS

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

BALANCE SHEET AS AT 31ST MARCH, 20____.

		Schedule	Current Year	Previous Year
			(₹000)	*(₹000)*
	Sources of Funds			
	Shareholders' Funds:			
	Share Capital	**5**		
	Reserves and Surplus	**6**		

	Credit/[Debit] Fair Value Change Account			
	Sub-Total			
	Borrowings	**7**		
	Policyholders' Funds:			
	Credit/[Debit] Fair Value Change Account			
	Policy Liabilities			
	Insurance Reserves			
	Provision for Linked Liabilities			
	Sub-Total			
	Funds for Future Appropriations			
	Total			
	Application of Funds			
	Investments			
	Shareholders'	**8**		
	Policyholders'	**8A**		
	Assets held to cover Linked Liabilities	**8B**		
	Loans	**9**		
	Fixed Assets	**10**		
	Current Assets			
	Cash and Bank Balances	**11**		
	Advances and Other Assets	**12**		
	Sub-Total (A)			
	Current Liabilities	**13**		
	Provisions	**14**		
	Sub-Total (B)			
	Net Current Assets (C) = (A – B)			
	Miscellaneous Expenditure (To the extent not written off or adjusted)	**15**		
	Debit Balance in Profit & Loss Account (Shareholders' Account)			
	Total			

CONTINGENT LIABILITIES

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Partly paid-up investments		
2.	Claims, other than against policies, not acknowledged as debts by the company		
3.	Underwriting commitments outstanding (in respect of shares and securities)		
4.	Guarantees given by or on behalf of the Company		
5.	Statutory demands/ liabilities in dispute, not provided for		
6.	Reinsurance obligations to the extent not provided for in accounts		
7.	Others (to be specified)		
	Total		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE – 1

PREMIUM

	Particulars	Current Year *(₹000)*	Previous Year *(₹000)*
1	First year premiums		
2	Renewal Premiums		
3	Single Premiums		
	TOTAL PREMIUM		

SCHEDULE- 2

COMMISSION EXPENSES

Particulars	Current Year *(₹000)*	Previous Year *(₹000)*
Commission paid		
Direct – First year premiums		
- Renewal premiums		
- Single premiums		
Add: Commission on Re-insurance Accepted		
Less: Commission on Re-insurance Ceded		
Net Commission		

Note: The profit/ commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE – 3

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

	Particulars	Current Year (₹000)	Previous Year (₹000)
1.	Employees' remuneration & welfare benefits		
2	Travel, conveyance and vehicle running expenses		
3	Training expenses		
4	Rents, rates & taxes		
5	Repairs		
6	Printing & stationery		
7	Communication expenses		
8	Legal & professional charges		
9	Medical fees		
10	Auditors' fees, expenses etc		
	a) as auditor		
	b) as adviser or in any other capacity, in respect of		
	(i) Taxation matters		
	(ii) Insurance matters		
	(iii) Management services; and		
	c) in any other capacity		
11	Advertisement and publicity		
12	Interest & Bank Charges		
13	Others (to be specified)		
14	Depreciation		
	TOTAL		

Note : Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE – 4

BENEFITS PAID [NET]

	Particulars	Current Year (₹000)	Previous Year (₹000)
1.	Insurance Claims Claims by Death, Claims by Maturity, Annuities/Pension payment, Other benefits, specify		

2.	(Amount ceded in reinsurance): (a) Claims by Death, (b) Claims by Maturity, (c) Annuities/Pension payment, (d) Other benefits, specify		
3.	Amount accepted in reinsurance: (a) Claims by Death, (b) Claims by Maturity, (c) Annuities/Pension payment, (d) Other benefits, specify		
	TOTAL		

Notes:

(a) Claims include specific claims settlement costs, wherever applicable.

(b) Legal and other fees and expenses shall also form part of the claims cost, wherever applicable.

SCHEDULE – 5

SHARE CAPITAL

	Particulars	**Current Year** (*₹000*)	**Previous Year** (*₹000*)
1.	Authorised Capital		
	Equity Shares of ₹.... each		
2.	Issued Capital		
	Equity Shares of ₹ .....each		
3.	Subscribed Capital		
	Equity Shares of ₹......each		
4.	Called-up Capital		
	Equity Shares of ₹ .....each		
	Less : Calls unpaid		
	Add : Shares forfeited (Amount originally paid up)		
	Less : Par value of Equity Shares bought back		
	Less : Preliminary Expenses Expenses including commission or brokerage on Underwriting or subscription of shares		
	TOTAL		

Notes:

(a) *Particulars of the different classes of capital should be separately stated.*

(b) *The amount capitalised on account of issue of bonus shares should be disclosed.*

(c) *In case any part of the capital is held by a holding company, the same should be separately disclosed.*

SCHEDULE – 5A

PATTERN OF SHAREHOLDING
[As certified by the Management]

Shareholder	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Promoters				
• Indian				
• Foreign				
Others				
TOTAL				

SCHEDULE – 6

RESERVES AND SURPLUS

	Particulars	Current Year (₹000)	Previous Year (₹000)
1.	Capital Reserve		
2.	Capital Redemption Reserve		
3	Share Premium		
4.	Revaluation Reserve		
5.	General Reserves		
	Less: Debit balance in Profit and Loss Account, if any		
	Less: Amount utilized for Buy-back		
6.	Catastrophe Reserve		
7.	Other Reserves (to be specified)		
8.	Balance of profit in Profit and Loss Account		
	TOTAL		

Note: *Additions to and deductions from the reserves shall be disclosed under each of the specified heads.*

SCHEDULE - 7

BORROWINGS

	Particulars	Current Year (₹000)	Previous Year (₹000)
1.	Debentures/ Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to be specified)		
	TOTAL		

Notes:

(a) *The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.*

(b) *Amounts due within 12 months from the date of Balance Sheet should be shown separately*

SCHEDULE – 8

INVESTMENTS-SHAREHOLDERS

	Particulars	Current Year	Previous Year
		(₹000)	(₹000)
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(aa) Equity		
	(bb) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/ Bonds		
	(e) Other Securities (to be specified)		
	(f) Subsidiaries		
	Investment Properties-Real Estate		

4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(aa) Equity		
	(bb) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/ Bonds		
	(e) Other Securities (to be specified)		
	(f) Subsidiaries		
	Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Note: See Notes appended at the end of Schedule- 8B

SCHEDULE- 8A

INVESTMENTS-POLICYHOLDERS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares		
	(aa) Equity		
	(bb) Preference		
	(b) Mutual Funds		

	(c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (a) Derivative Instruments (b) Debentures/ Bonds (c) Other Securities (to be specified) (d) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Note: See Notes appended at the end of Schedule- 8B

SCHEDULE- 8B

ASSETS HELD TO COVER LINKED LIABILITIES

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments		

	(d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	(a) Shares (aa) Equity (bb) Preference (b) Mutual Funds (c) Derivative Instruments (d) Debentures/ Bonds (e) Other Securities (to be specified) (f) Subsidiaries (g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Notes *(applicable to Schedules 8 and 8A & 8B):*

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) Holding company and subsidiary shall be construed as defined in the Companies Act, 2013:

(ii) Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) Joint control - is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) Associate - is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) Significant influence (for the purpose of this schedule) -means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation

on the board of directors, participation in the policymaking process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 percent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 percent of the voting power of the investee, it is presumed that the investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.

(c) Investment made out of Catastrophe reserve should be shown separately.

(d) Debt securities will be considered as "held to maturity" securities and will be measured at historical costs subject to amortisation

(e) Investment Property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.

(f) Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall be classified as short-term investments

SCHEDULE - 9

LOANS

	Particulars	**Current Year**	**Previous Year**
		(₹000)	*(₹000)*
1.	SECURITY-WISE CLASSIFICATION		
	Secured		
	(a) On mortgage of property		
	(aa) In India		
	(bb) Outside India		
	(b) On Shares, Bonds, Govt. Securities, etc.		
	(c) Loans against policies		
	(d) Others (to be specified)		
	Unsecured		
	TOTAL		

2.	BORROWER-WISE CLASSIFICATION (a) Central and State Governments (b) Banks and Financial Institutions (c) Subsidiaries (d) Companies (e) Loans against policies (f) Others (to be specified) **TOTAL**		
3.	PERFORMANCE-WISE CLASSIFICATION (a) Loans classified as standard (aa) In India (bb) Outside India (b) Non-standard loans less provisions (aa) In India (bb) Outside India **TOTAL**		
4.	MATURITY-WISE CLASSIFICATION (a) Short Term (b) Long Term **TOTAL**		

Notes:

(a) *Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.*

(b) *Provisions against non-performing loans shall be shown separately.*

(c) *The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.*

(d) *Loans considered doubtful and the amount of provision created against such loans shall* be disclosed.

SCHEDULE - 10

FIXED ASSETS

(₹000)

Particulars	**Cost/ Gross Block**				**Depreciation**				**Net Block**	
	Opening	Additions	Deductions	Closing	Up to Last Year	For The Year	On Sales/ Adjustments	To Date	As at year end	Previous Year
Goodwill										

Intangibles (specify)										
Land- Freehold										
Leasehold Property										
Buildings										
Furniture & Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work in progress										
Grand Total										
PREVIOUS YEAR										

Note: *Assets included in land, property and building above exclude Investment Properties as defined in note (e) to Schedule 8.*

SCHEDULE- 11

CASH AND BANK BALANCES

	Particulars	**Current Year**	**Previous Year**
		(₹000)	*(₹000)*
1.	Cash (including cheques, drafts and stamps)		
2.	Bank Balances		
	(a) Deposit Accounts		
	(aa) Short-term (due within 12 months of the date of Balance Sheet)		
	(bb) Others		
	(b) Current Accounts		
	(c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		

	(b) With other Institutions		
4.	Others (to be specified)		
	TOTAL		
	Balances with non-scheduled banks included in 2 and 3 above		
	CASH & BANK BALANCES		
1	In India		
2	Outside India		
	TOTAL		

Note: *Bank balance may include remittances in transit. If so, the nature and amount shall be separately stated.*

SCHEDULE – 12

ADVANCES AND OTHER ASSETS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
	ADVANCES		
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	TOTAL (A)		
	OTHER ASSETS		
1.	Income accrued on investments		
2.	Outstanding Premiums		
3.	Agents' Balances		
4.	Foreign Agencies Balances		
5	Due from other entities carrying on insurance business (including reinsures)		
6.	Due from subsidiaries/ holding company		
7.	Deposit with Reserve Bank of India [Pursuant to section 7 of Insurance Act, 1938]		

8.	Others (to be specified) **TOTAL (B)** **TOTAL (A+B)**		

Notes:

(a) *The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.*

(b) *The term 'officer' should conform to the definition of that term as given under the Companies Act, 2013.*

(c) *Sundry debtors will be shown under item 8 (Others)*

SCHEDULE – 13

CURRENT LIABILITIES

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated premium		
6.	Sundry creditors		
7.	Due to subsidiaries/ holding company		
8.	Claims Outstanding		
9.	Annuities Due		
10.	Due to Officers/ Directors		
11.	Others (to be specified)		
	TOTAL		

SCHEDULE – 14

PROVISIONS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	For taxation (less payments and taxes deducted at source)		
2.	For proposed dividends		

3.	For dividend distribution tax		
4.	Others (to be specified)		
	TOTAL		

SCHEDULE – 15

MISCELLANEOUS EXPENDITURE
(To the extent not written off or adjusted)

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Discount Allowed in issue of shares/ debentures		
2.	Others (to be specified)		
	TOTAL		

Notes:

(a) No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:

1 some benefit from the expenditure can reasonably be expected to be received in future, and

2 the amount of such benefit is reasonably determinable.

(b) The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.

ANNEXURE II

SCHEDULE B for General Insurance Business

PART I: Accounting principles for preparation of financial statements

1. Applicability of Accounting Standards---Every Balance Sheet, Receipts and Payments Account [Cash Flow statement] and Profit and Loss Account [Shareholders' Account] of the insurer shall be in conformity with the Accounting Standards (AS) issued by the ICAI, to the extent applicable to the insurers carrying on general insurance business, except that:

1. Accounting Standard 3 (AS 3) – Cash Flow Statements – Cash Flow Statement shall be prepared only under the Direct Method.
2. Accounting Standard 13 (AS 13) – Accounting for Investments, shall not be applicable.
3. Accounting Standard 17 (AS 17) - Segment Reporting – shall apply to all insurers irrespective of the requirements regarding listing and turnover mentioned therein.

2. Premium--Premium shall be recognised as income over the contract period or the period of risk, whichever is appropriate. Premium received in advance, which represents premium income not relating to the current accounting period, shall be disclosed separately in the financial statements.

A reserve for unexpired risks shall be created as the amount representing that part of the premium written which is attributable to, and to be allocated to the succeeding accounting periods and shall not be less than as required under section 64 V(1) (ii) (b) of the Act.

Premium Received in Advance, which represents premium received prior to the commencement of the risk, shall be shown separately under the head '*Current Liabilities'* in the financial statements.

3. Premium Deficiency--Premium deficiency shall be recognised if the sum of expected claim costs, related expenses and maintenance costs exceeds related reserve for unexpired risks.

4. Acquisition Costs---Acquisition costs, if any, shall be expensed in the period in which they are incurred.

Acquisition costs are those costs that vary with, and are primarily related to, the acquisition of new and renewal insurance contracts. The most essential test is the obligatory relationship between costs and the execution of insurance contracts (i.e. commencement of risk).

5. Claims--The components of the ultimate cost of claims to an insurer comprise the claims under policies and specific claims settlement costs. Claims under policies comprise the claims made for losses incurred, and those estimated or anticipated under the policies following a loss occurrence.

A liability for outstanding claims shall be brought to account in respect of both direct business and inward reinsurance business. The liability shall include: -

(a) Future payments in relation to unpaid reported claims;

(b) Claims Incurred But Not Reported (IBNR) including inadequate reserves [sometimes referred to as Claims Incurred But Not Enough Reported (IBNER)],

which will result in future cash/asset outgo for settling liabilities against those claims. Change in estimated liability represents the difference between the estimated liability for outstanding claims at the beginning and at the end of the financial period.

The accounting estimate shall also include claims cost adjusted for estimated salvage value if there is sufficient degree of certainty of its realisation.

Actuarial Valuation of claim liability – in some cases

Claims made in respect of contracts where the claims payment period exceeds four years shall be recognised on an actuarial basis, subject to regulations that may be prescribed by the Authority. In such cases, certificate from a recognised actuary as to the fairness of liability assessment must be obtained. Actuarial assumptions shall be suitably disclosed by way of notes to the account.

6. Procedure to determine the value of investments.---An insurer shall determine the values of investments in the following manner:-

(a) Real Estate – Investment Property-- Investment Property shall be measured at historical cost less accumulated depreciation and impairment loss, residual value being considered zero and no revaluation being permissible.

The Insurer shall assess at each balance sheet date whether any impairment of the investment property has occurred.

An impairment loss shall be recognised as an expense in the Revenue/Profit and Loss Account immediately.

Fair value as at the balance sheet date and the basis of its determination shall be disclosed in the financial statements as additional information.

(b) Debt Securities--Debt securities including government securities and redeemable preference shares shall be considered as "held to maturity" securities and shall be measured at historical cost subject to amortisation.

(c) Equity Securities and Derivative Instruments that are traded in active markets--- Listed equity securities and derivative instruments that are traded in active markets shall be measured at fair value as at the balance sheet date. For the purpose of calculation of fair value, the lowest of the last quoted closing price of the stock exchanges where the securities are listed shall be taken.

The insurer shall assess on each balance sheet date whether any impairment of listed equity security(ies)/ derivative(s) instruments has occurred.

An active market shall mean a market, where the securities traded are homogenous, availability of willing buyers and willing sellers is normal and the prices are publicly available.

Unrealised gains/losses arising due to changes in the fair value of listed equity shares and derivative instruments shall be taken to equity under the head 'Fair Value Change Account'. The 'Profit on sale of investments' or 'Loss on sale of investments', as the case may be, shall include accumulated changes in the fair value previously recognised in equity under the heading Fair Value Change Account in respect of a particular security and being recycled to Profit and Loss Account on actual sale of that listed security.

For the removal of doubt, it is clarified that balance or any part thereof shall not be available for distribution as dividends. Also, any debit balance in the said Fair Value Change Account shall be reduced from the profits/free reserves while declaring dividends.

The insurer shall assess, at each balance sheet date, whether any impairment has occurred. An impairment loss shall be recognised as an expense in Revenue/Profit and Loss Account to the extent of the difference between the remeasured fair value of the security/ investment and its acquisition cost as reduced by any previous impairment loss recognised as expense in Revenue/Profit and Loss Account. Any reversal of impairment loss, earlier recognised in Revenue/Profit and Loss Account shall be recognised in Revenue/Profit and Loss Account.

(d) Unlisted and other than actively traded Equity Securities and Derivative Instruments--Unlisted equity securities and derivative instruments and listed equity securities and derivative instruments that are not regularly traded in active market will be measured at historical costs. Provision shall be made for diminution in value of such investments. The provision so made shall be reversed in subsequent periods if estimates based on external evidence show an increase in the value of the investment over its carrying amount. The increased carrying amount of the investment due to the reversal of the provision shall not exceed the historical cost.

For the purposes of this regulation, a security shall be considered as being not actively traded, if as per guidelines governing mutual funds laid down from time to time by SEBI, such a security is classified as "thinly traded".

7. Loans--Loans shall be measured at historical cost subject to impairment provisions.

The insurer shall assess the quality of its loan assets and shall provide for impairment. The impairment provision shall not be lower than the amounts derived on the basis of guidelines prescribed from time to time by the Reserve Bank of India, that apply to companies and financial institutions.

8. Catastrophe Reserve -- Catastrophe reserve shall be created in accordance with norms, if any, prescribed by the Authority. Investment of funds out of catastrophe reserve shall be made in accordance with prescription of the Authority.

PART II: Disclosures forming part of Financial Statements

A. The following shall be disclosed by way of notes to the Balance Sheet:

1. Contingent Liabilities:
   - (a) Partly-paid up investments
   - (b) Underwriting commitments outstanding
   - (c) Claims, other than those under policies, not acknowledged as debts
   - (d) Guarantees given by or on behalf of the company
   - (e) Statutory demands/liabilities in dispute, not provided for
   - (f) Reinsurance obligations to the extent not provided for in accounts
   - (g) Others (to be specified)
2. Encumbrances to assets of the company in and outside India.
3. Commitments made and outstanding for Loans, Investments and Fixed Assets.
4. Claims, less reinsurance, paid to claimants in/outside India.

5. Actuarial assumptions for determination of claim liabilities in the case of claims where the claims payment period exceed four years.
6. Ageing of claims – distinguishing between claims outstanding for more than six months and other claims.
7. Premiums, less reinsurance, written from business in/outside India.
8. Extent of premium income recognised, based on varying risk pattern, category wise, with basis and justification therefor, including whether reliance has been placed on external evidence.
9. Value of contracts in relation to investments, for:
   (a) Purchases where deliveries are pending;
   (b) Sales where payments are overdue.
10. Operating expenses relating to insurance business: basis of allocation of expenditure to various classes of business.
11. Historical costs of those investments valued on fair value basis.
12. Computation of managerial remuneration.
13. Basis of amortisation of debt securities.
14. (a) Unrealised gain/losses arising due to changes in the fair value of listed equity shares and derivative instruments are to be taken to equity under the head 'Fair Value Change Account' and on realisation reported in profit and loss Account.
    (b) Pending realisation, the credit balance in the 'Fair Value Change Account' is not available for distribution.
15. Fair value of investment property and the basis therefor.
16. Claims settled and remaining unpaid for a period of more than six months as on the balance sheet date.

B. The following accounting policies shall form an integral part of the financial statements:

1. All significant accounting policies in terms of the accounting standards issued by the ICAI, and significant principles and policies given in Part I of Accounting Principles. Any other accounting policies followed by the insurer shall be stated in the manner required under Accounting Standard AS 1 issued by the ICAI.
2. Any departure from the accounting policies as aforesaid shall be separately disclosed with reasons for such departure.

C. The following information shall also be disclosed:

1. Investments made in accordance with any statutory requirement should be disclosed separately together with its amount, nature, security and any special rights in and outside India.
2. Segregation into performing/ non performing investments for purpose of income recognition as per the directions, if any, issued by the Authority.
3. Percentage of business sector-wise.
4. A summary of financial statements for the last five years, in the manner as may be prescribed by the Authority.
5. Accounting Ratios as may be prescribed by the Authority.
6. Basis of allocation of Interest, Dividends and Rent between Revenue Account and Profit and Loss Account.

PART III: GENERAL INSTRUCTIONS FOR PREPARATION OF FINANCIAL STATEMENTS

1. The corresponding amounts for the immediately preceding financial year for all items shown in the Balance Sheet, Revenue Account and Profit and Loss Account should be given.
2. The figures in the financial statements may be rounded off to the nearest thousands.
3. Interest, dividends and rentals receivable in connection with an investment should be stated as gross value, the amount of income tax deducted at source being included under 'advance taxes paid'.
4. Income from rent shall not include any notional rent.
5. (I) For the purposes of financial statements, unless the context otherwise requires -
    (a) the expression ‘provision’ shall, subject to note II below mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or retained by way of providing for any known liability or loss of which the amount cannot be determined with substantial accuracy;
    (b) the expression "reserve" shall not, subject to as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;
    (c) the expression capital reserve shall not include any amount regarded as free for distribution through the profit and loss account; and the expression "revenue reserve" shall mean any reserve other than a capital reserve;
    (d) The expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(II) Where:

(a) any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, or

(b) any amount retained by way of providing for any known liability is in excess of the amount which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of these accounts as a reserve and not as a provision.

1. The company should make provisions for damages under lawsuits where the management is of the opinion that the award may go against the insurer.
2. Extent of risk retained and reinsured shall be separately disclosed.
3. Any debit balance of Profit and Loss Account shall be shown as deduction from uncommitted reserves and the balance if any, shall be shown separately.

PART IV: CONTENTS OF MANAGEMENT REPORT

There shall be attached to the financial statements, a management report duly authenticated by the management.

PART V: Preparation of Financial Statements

(1) An insurer shall prepare the Revenue Account, Profit and Loss Account [Shareholders' Account] and the Balance Sheet in Form B-RA, Form B-PL, and Form B-BS, or as near thereto as the circumstances permit.

Provided that an insurer shall prepare Revenue Accounts separately for fire, marine, and miscellaneous insurance business and separate schedules shall be prepared for Marine Cargo, Marine – Other than Marine Cargo and the following classes of miscellaneous insurance business under miscellaneous insurance and accordingly application of AS 17 – Segment Reporting - shall stand modified.

1. Motor 2. Workmen's Compensation/Employers' Liability

3. Public/Product Liability 4. Engineering

5. Aviation 6. Personal Accident

7. Health Insurance 8. Others

(2) An insurer shall prepare separate Receipts and Payments Account in accordance with the Direct Method prescribed in AS 3 – "Cash Flow Statement" issued by the ICAI.

FORM B-RA

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

REVENUE ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

	Particulars	Schedule	Current Year	Previous Year
			(₹'000)	(₹'000)
1.	Premiums earned (Net)	1		
2.	Profit/ Loss on sale/redemption of Investments			
3.	Others (to be specified)			
4.	Interest, Dividend & Rent – Gross			
	TOTAL (A)			
1.	Claims Incurred (Net)	2		
2.	Commission	3		
3.	Operating Expenses related to Insurance Business	4		
	TOTAL (B)			
	Operating Profit/(Loss) from Fire/Marine/Miscellaneous Business C= (A - B)			
	APPROPRIATIONS			
	Transfer to Shareholders' Account			
	Transfer to Catastrophe Reserve			
	Transfer to Other Reserves (to be specified)			
	TOTAL (C)			

FORM B-PL

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 20___.

	Particulars	Schedule	Current Year	Previous Year
			(₹000)	*(₹000)*
1.	OPERATING PROFIT/(LOSS)			
	(a) Fire Insurance			
	(b) Marine Insurance			

	(c) Miscellaneous Insurance			
2.	INCOME FROM INVESTMENTS			
	(a) Interest, Dividend & Rent – Gross			
	(b) Profit on sale of investments			
	Less: Loss on sale of investments			
3.	OTHER INCOME (To be specified)			
	TOTAL (A)			
4.	PROVISIONS (Other than taxation)			
	(a) For diminution in the value of investments			
	(b) For doubtful debts			
	(c) Others (to be specified)			
5.	OTHER EXPENSES			
	(a) Expenses other than those related to Insurance Business			
	(b) Bad debts written off			
	(c) Others (To be specified)			
	TOTAL (B)			
	Profit Before Tax			
	Provision for Taxation			
	APPROPRIATIONS			
	(a) Interim dividends paid during the year			
	(b) Proposed final dividend			
	(c) Dividend distribution tax			
	(d) Transfer to any Reserves or Other Accounts (to be specified)			
	Balance of profit/ loss brought forward from last year			
	Balance carried forward to Balance Sheet			

Notes: *to Form B-RA and B- PL*

(a) *Premium income received from business concluded in and outside India shall be separately disclosed.*

(b) *Reinsurance premiums whether on business ceded or accepted are to be brought into account gross (i.e. before deducting commissions) under the head reinsurance premiums.*

(c) *Claims incurred shall comprise claims paid, specific claims settlement costs wherever applicable and change in the outstanding provision for claims at the year-end,.*

(d) *Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹ 5,00,000 whichever is higher, shall be shown as a separate line item.*

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

(f) *Under the sub-head "Others" shall be included items like foreign exchange gains or losses and other items.*

(g) *Interest, dividends and rentals receivable in connection with an investment should be stated as gross amount, the amount of income tax deducted at source being included under 'advance taxes paid and taxes deducted at source"..*

(h) *Income from rent shall include only the realised rent. It shall not include any notional rent.*

FORM B-BS

Name of the Insurer:

Registration No. and Date of Registration with the IRDA

BALANCE SHEET AS AT 31ST MARCH, 20___.

		Schedule	Current Year	Previous Year
			(₹000)	*(₹000)*
	Sources of Funds			
	Share Capital	**5**		
	Reserves and Surplus	**6**		
	Fair Value Change Account			
	Borrowings	**7**		
	Total			
	Application of Funds			
	Investments	**8**		
	Loans	**9**		
	Fixed Assets	**10**		
	Current Assets			
	Cash and Bank Balances	**11**		
	Advances and Other Assets	**12**		
	Sub-Total (A)			
	Current Liabilities	**13**		
	Provisions	**14**		
	Sub-Total (B)			
	Net Current Assets (C) = (A - B)			
	Miscellaneous Expenditure (To the extent not written off or adjusted)	**15**		
	Debit Balance in Profit And Loss Account			
	Total			

CONTINGENT LIABILITIES

	Particulars	Current Year	Previous Year
		(₹000)	(₹000)
1.	Partly paid-up investments		
2.	Claims, other than against policies, not acknowledged as debts by the company		
3.	Underwriting commitments outstanding (in respect of shares and securities)		
4.	Guarantees given by or on behalf of the Company		
5.	Statutory demands/ liabilities in dispute, not provided for		
6.	Reinsurance obligations to the extent not provided for in accounts		
7.	Others (to be specified)		
	TOTAL		

SCHEDULES FORMING PART OF FINANCIAL STATEMENTS

SCHEDULE – 1

PREMIUM EARNED [NET]

	Particulars	Current Year	Previous Year
		(₹000)	(₹000)
	Premium from direct business written		
	Add: Premium on reinsurance accepted		
	Less : Premium on reinsurance ceded		
	Net Premium		
	Adjustment for change in reserve for unexpired risks		
	Total Premium Earned (Net)		

Note: Reinsurance premiums whether on business ceded or accepted are to be brought into account, before deducting commission, under the head of reinsurance premiums.

SCHEDULE – 2

CLAIMS INCURRED [NET]

	Particulars	Current Year	Previous Year
		(₹000)	(₹000)
	Claims paid		
	Direct		

	Add :Re-insurance accepted *Less* :Re-insurance Ceded Net Claims paid *Add* Claims Outstanding at the end of the year *Less* Claims Outstanding at the beginning **Total Claims Incurred**		

Notes:

(a) Incurred But Not Reported (IBNR), Incurred but not enough reported [IBNER] claims should be included in the amount for outstanding claims.

(b) Claims includes specific claims settlement cost but not expenses of management

(c) The surveyor fees, legal and other expenses shall also form part of claims cost.

(d) Claims cost should be adjusted for estimated salvage value if there is a sufficient certainty of its realisation.

SCHEDULE- 3

COMMISSION

Particulars	Current Year	Previous Year
	(₹000)	*(₹000)*
Commission paid Direct *Add:* Re-insurance Accepted *Less:* Commission on Re-insurance Ceded Net Commission		

Note: The profit/ commission, if any, are to be combined with the Re-insurance accepted or Re-insurance ceded figures.

SCHEDULE – 4

OPERATING EXPENSES RELATED TO INSURANCE BUSINESS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Employees' remuneration & welfare benefits		
2.	Travel, conveyance and vehicle running expenses		
3.	Training expenses		
4.	Rents, rates & taxes		
5.	Repairs		

6.	Printing & stationery		
7.	Communication		
8.	Legal & professional charges		
9.	Auditors' fees, expenses etc		
	(a) as auditor		
	(b) as adviser or in any other capacity, in respect of		
	(i) Taxation matters		
	(ii) Insurance matters		
	(iii) Management services; and		
	(c) in any other capacity		
10.	Advertisement and publicity		
11.	Interest & Bank Charges		
12.	Others (to be specified)		
13.	Depreciation		
	TOTAL		

Note: Items of expenses and income in excess of one percent of the total premiums (less reinsurance) or ₹5,00,000 whichever is higher, shall be shown as a separate line item.

SCHEDULE – 5

SHARE CAPITAL

	Particulars	**Current Year**	**Previous Year**
		(₹000)	*(₹000)*
1.	Authorised Capital		
	Equity Shares of ₹.... each		
2.	Issued Capital		
	Equity Shares of ₹ .....each		
3.	Subscribed Capital		
	Equity Shares of ₹......each		
4.	Called-up Capital		
	Equity Shares of ₹ .....each		
	Less : Calls unpaid		
	Add : Equity Shares forfeited (Amount originally paid up)		
	Less : Par Value of Equity Shares bought back		
	Less : Preliminary Expenses including commission or brokerage on Underwriting or subscription of shares		
	TOTAL		

Notes:

(a) *Particulars of the different classes of capital should be separately stated.*

(b) *The amount capitalised on account of issue of bonus shares should be disclosed.*

(c) *In case any part of the capital is held by a holding company, the same should be separately disclosed.*

SCHEDULE – 5A

SHARE CAPITAL
PATTERN OF SHAREHOLDING
[As certified by the Management]

Shareholder	Current Year		Previous Year	
	Number of Shares	% of Holding	Number of Shares	% of Holding
Promoters • Indian • Foreign Others TOTAL				

SCHEDULE – 6

RESERVES AND SURPLUS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Capital Reserve		
2.	Capital Redemption Reserve		
3	Share Premium		
4	General Reserves Less: Debit balance in Profit and Loss Account Less: Amount utilized for Buy-back		
5	Catastrophe Reserve		
6	Other Reserves (to be specified)		
7	Balance of Profit in Profit & Loss Account		
	TOTAL		

Note: *Additions to and deductions from the reserves should be disclosed under each of the specified heads.*

SCHEDULE - 7

BORROWINGS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
1.	Debentures/ Bonds		
2.	Banks		
3.	Financial Institutions		
4.	Others (to be specified)		
	TOTAL		

Notes:

(a) The extent to which the borrowings are secured shall be separately disclosed stating the nature of the security under each sub-head.

(b) Amounts due within 12 months from the date of Balance Sheet should be shown separately

SCHEDULE –8

INVESTMENTS

	Particulars	Current Year	Previous Year
		(₹000)	*(₹000)*
	LONG TERM INVESTMENTS		
1.	Government securities and Government guaranteed bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(aa) Equity		
	(bb) Preference		
	(b) Mutual Funds		
	(c) Derivative Instruments		
	(d) Debentures/ Bonds		
	(e) Other Securities (to be specified)		
	(f) Subsidiaries		
	(g) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	SHORT TERM INVESTMENTS		
1.	Government securities and Government guaranteed		

	bonds including Treasury Bills		
2.	Other Approved Securities		
3.	Other Investments		
	(a) Shares		
	(aa) Equity		
	(bb) Preference		
	(b) Mutual Funds		
	(a) Derivative Instruments		
	(b) Debentures/ Bonds		
	(c) Other Securities (to be specified)		
	(d) Subsidiaries		
	(e) Investment Properties-Real Estate		
4.	Investments in Infrastructure and Social Sector		
5.	Other than Approved Investments		
	TOTAL		

Notes:

(a) Investments in subsidiary/holding companies, joint ventures and associates shall be separately disclosed, at cost.

(i) Holding company and subsidiary shall be construed as defined in the Companies Act, 2013:

(ii) Joint Venture is a contractual arrangement whereby two or more parties undertake an economic activity, which is subject to joint control.

(iii) Joint control - is the contractually agreed sharing of power to govern the financial and operating policies of an economic activity to obtain benefits from it.

(iv) Associate - is an enterprise in which the company has significant influence and which is neither a subsidiary nor a joint venture of the company.

(v) Significant influence (for the purpose of this schedule) - means participation in the financial and operating policy decisions of a company, but not control of those policies. Significant influence may be exercised in several ways, for example, by representation on the board of directors, participation in the policymaking process, material inter-company transactions, interchange of managerial personnel or dependence on technical information. Significant influence may be gained by share ownership, statute or agreement. As regards share ownership, if an investor holds, directly or indirectly through subsidiaries, 20 percent or more of the voting power of the investee, it is presumed that the investor does have significant influence, unless it can be clearly demonstrated that this is not the case. Conversely, if the investor holds, directly or indirectly through subsidiaries, less than 20 percent of the voting power of the investee, it is presumed that the

investor does not have significant influence, unless such influence is clearly demonstrated. A substantial or majority ownership by another investor does not necessarily preclude an investor from having significant influence.

(b) *Aggregate amount of company's investments other than listed equity securities and derivative instruments and also the market value thereof shall be disclosed.*

(c) *Investments* made out of Catastrophe reserve should be shown separately.

(d) *Debt securities will be considered as "held to maturity" securities and will be measured at historical cost subject to amortisation.*

(e) *Investment Property means a property [land or building or part of a building or both] held to earn rental income or for capital appreciation or for both, rather than for use in services or for administrative purposes.*

(f) *Investments maturing within twelve months from balance sheet date and investments made with the specific intention to dispose of within twelve months from balance sheet date shall be classified as short-term investments*

SCHEDULE - 9

LOANS

	Particulars	**Current Year**	**Previous Year**
		(₹'000)	(₹'000)
1.	SECURITY-WISE CLASSIFICATION		
	Secured		
	(a) On mortgage of property		
	(aa) In India		
	(bb) Outside India		
	(b) On Shares, Bonds, Govt. Securities		
	(c) Others (to be specified)		
	Unsecured		
	TOTAL		
2.	BORROWER-WISE CLASSIFICATION		
	(a) Central and State Governments		
	(b) Banks and Financial Institutions		
	(c) Subsidiaries		
	(d) Industrial Undertakings		
	(e) Others (to be specified)		
	TOTAL		
3.	PERFORMANCE-WISE CLASSIFICATION		

	(a) Loans classified as standard (aa) In India (bb) Outside India (b) Non-performing loans less provisions (aa) In India (bb) Outside India		
	TOTAL		
4.	MATURITY-WISE CLASSIFICATION (a) Short Term (b) Long Term		
	TOTAL		

Notes:

(a) *Short-term loans shall include those, which are repayable within 12 months from the date of balance sheet. Long term loans shall be the loans other than short-term loans.*

(b) *Provisions against non-performing loans shall be shown separately.*

(c) *The nature of the security in case of all long term secured loans shall be specified in each case. Secured loans for the purposes of this schedule, means loans secured wholly or partly against an asset of the company.*

(d) *Loans considered doubtful and the amount of provision created against such loans shall be disclosed.*

SCHEDULE – 10

FIXED ASSETS

(₹000)

Particulars	**Cost/ Gross Block**				**Depreciation**				**Net Block**	
	Opening	Additions	Deductions	Closing	Upto Last Year	For The Year	On Sales/ Adjustments	To Date	As at year end	Previous Year
Goodwill Intangibles (specify) Land-Freehold Leasehold Property Buildings Furniture &										

Fittings										
Information Technology Equipment										
Vehicles										
Office Equipment										
Others (Specify nature)										
TOTAL										
Work in progress										
Grand Total										
PREVIOUS YEAR										

Note: *Assets included in land, building and property above exclude Investment Properties as defined in note (e) to Schedule 8.*

SCHEDULE- 11

CASH AND BANK BALANCES

	Particulars	Current Year	Previous Year
		(₹'000)	(₹'000)
1.	Cash (including cheques, drafts and stamps)		
2.	Bank Balances		
	(a) Deposit Accounts		
	(aa) Short-term (due within 12 months)		
	(bb) Others		
	(b) Current Accounts		
	(c) Others (to be specified)		
3.	Money at Call and Short Notice		
	(a) With Banks		
	(b) With other Institutions		
4.	Others (to be specified)		
	TOTAL		
	Balances with non-scheduled banks included in 2 and 3 above		

Note : *Bank balance may include remittances in transit. If so, the nature and amount should be separately stated.*

SCHEDULE – 12

ADVANCES AND OTHER ASSETS

	Particulars	Current Year	Previous Year
		(₹'000)	(₹'000)
	ADVANCES		
1.	Reserve deposits with ceding companies		
2.	Application money for investments		
3.	Prepayments		
4.	Advances to Directors/Officers		
5.	Advance tax paid and taxes deducted at source (Net of provision for taxation)		
6.	Others (to be specified)		
	TOTAL (A)		
	OTHER ASSETS		
1.	Income accrued on investments		
2.	Outstanding Premiums		
3.	Agents' Balances		
4.	Foreign Agencies Balances		
5.	Due from other entities carrying on insurance business (including reinsures)		
6.	Due from subsidiaries/ holding		
7.	Deposit with Reserve Bank of India		
	[Pursuant to section 7 of Insurance Act, 1938]		
8.	Others (to be specified)		
	TOTAL (B)		
	TOTAL (A+B)		

Notes:

(a) *The items under the above heads shall not be shown net of provisions for doubtful amounts. The amount of provision against each head should be shown separately.*

(b) The term 'officer' should conform to the definition of that term as given under the Companies Act, 2013.

(c) Sundry Debtors will be shown under item 9(others)

SCHEDULE – 13

CURRENT LIABILITIES

	Particulars	**Current Year**	**Previous Year**
		(₹000)	*(₹000)*
1.	Agents' Balances		
2.	Balances due to other insurance companies		
3.	Deposits held on re-insurance ceded		
4.	Premiums received in advance		
5.	Unallocated Premium		
6.	Sundry creditors		
7.	Due to subsidiaries/ holding company		
8.	Claims Outstanding		
9.	Due to Officers/ Directors		
10.	Others (to be specified)		
	TOTAL		

SCHEDULE – 14

PROVISIONS

	Particulars	**Current Year**	**Previous Year**
		(₹'000)	(₹'000)
1	Reserve for Unexpired Risk		
2	For taxation (less advance tax paid and taxes deducted at source)		
3	For proposed dividends		
4	For dividend distribution tax		
5	Others (to be specified)		
	TOTAL		

SCHEDULE – 15

MISCELLANEOUS EXPENDITURE
(To the extent not written off or adjusted)

	Particulars	Current Year	Previous Year
		(₹'000)	(₹'000)
1.	Discount Allowed in issue of shares/ debentures		
2.	Others (to be specified)		
	TOTAL		

Notes:

(a) *No item shall be included under the head "Miscellaneous Expenditure" and carried forward unless:*

1. *some benefit from the expenditure can reasonably be expected to be received in future, and*
2. *the amount* of such benefit is reasonably determinable.

(b) *The amount to be carried forward in respect of any item included under the head "Miscellaneous Expenditure" shall not exceed the expected future revenue/other benefits related to the expenditure.*

6

Financial Statements of Banking Companies

Unit-1: Some Relevant Provisions of the Banking Regulations Act, 1949

Learning Objectives

After studying this unit, you will be able to:

- ♦ Understand the legal definition of banking, the composition of management team of a bank and types of banks operating in India.
- ♦ Learn the conditions to be fulfilled for obtaining a license for banking activities in India.
- ♦ Learn the provisions relating to capital, reserve, liquidity norm (Capital Reserve Ratio & Statutory Liquidity Ratio), reserve fund, dividend payment and disposal of non-banking assets.
- ♦ Try to relate such provisions with the financial information obtained from any banking companies.

1.1 Meaning of Banking

Banks are vital to the prosperity and well being of any society or country. Banks enable a society to create the platform for the satisfaction of wants of its people by managing and maintaining the flow of money to carry out transactions. The role of banks may be likened to the heart in a human being, circulating and managing money through the economy, thereby playing a crucial role for its good health.

Banks in India and their activities are regulated by the Banking Regulation Act, 1949.

Banking : Under Section 5(*b*) of the said Act "Banking" means,

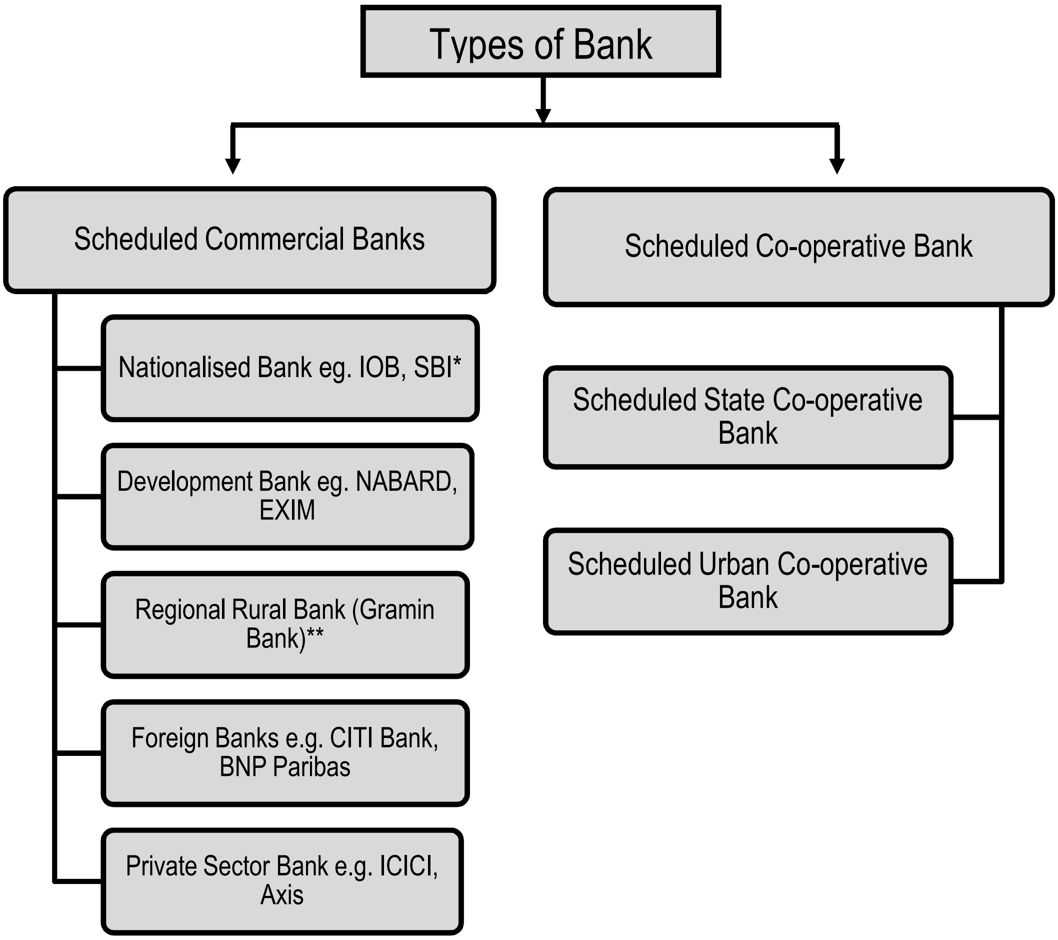
- ➢ Accepting deposits of money from public for the purpose of lending
- ➢ These deposits are repayable on demand and can be withdrawn by cheque, draft or otherwise

Banking Company: Any bank which transacts this business as stated in section 5 (b) of the act in India is called a banking company. However merely accepting public deposits by a company for financing its own business shall not make it a bank. It may be mentioned that the Banking Regulation Act, 1949 is not applicable to a primary agricultural society, a co-operative land mortgage bank and any other co-operative society.

1.1.1 Types of banks: There are two main categories of Commercial Bank in India namely:-

1. Scheduled Commercial Bank
2. Scheduled Co-operative Bank

Scheduled Commercial Banks are again divided into five types and the Scheduled Co-operative Banks into two as given in the following chart.



* There are so far 26 Nationalised bank including SBI and its subsidiaries.

** There are 82 Regional Rural Banks (RRBs) as on 01.01.2012. RRB's are conceived as low cost institutions having a rural ethos, local feel and pro-poor focus.

Scheduled Banks in India constitute those banks which have been included in the Second Schedule of Reserve Bank of India (RBI) Act, 1934. After May 1997 there are no non-scheduled commercial banks existing in India. However there are small to tiny non-scheduled Urban Co-operative Banks also known as Nidhi's in some parts of the country.

The banks included in this schedule list should fulfill following two conditions:

1. The paid up capital and reserves in aggregate should not be less than ₹ 5 lakhs.
2. Any activity of the bank will not adversely affect the interests of depositors.

The Reserve Bank includes a bank in this schedule if it fulfils certain other conditions too.

RBI as the Central Bank is the 'Bank of Last Resort' i.e. when other commercial banks are in trouble RBI helps them out. The services provided by RBI to scheduled commercial banks includes the following:

(a) The purchase, sale, and re-discounting of certain bills of exchange, or promissory notes.

(b) Purchase and sale of foreign exchange.

(c) Purchase, sale and re-discounting of foreign bills of exchange.

(d) Making of loans and advances to scheduled banks.

(e) Maintenance of accounts of the scheduled bank in its banking department and issue department.

(f) Remittance of money between different branches of scheduled banks through the offices, branches or agencies of Reserve Bank free of cost or at nominal rates.

1.1.2 Banking Company Business: Section 6 of the Banking Regulation Act, 1949 specifies the forms of business in which a banking company may engage. These are:

Main Business:-

(i) borrowing, raising or taking up of money, lending or advancing of money; handling in all manners Bills of exchange/hundies/promissory notes

(ii) acting as agents for any government or local authority or any other person,

(iii) contracting for public or private loans

(iii) the effecting, issuing, guaranteeing underwriting, participating in the managing and carrying out of any issue public or private, of State, municipal or other loans or of shares, stocks, debentures, debenture stock of any company, corporation or association and the lending of money for the purpose of any such issue.

Other Business:-

(v) carrying on and transacting every kind of guarantee and indemnity business.

(vi) managing, selling and realising property which may come into the possession of the banking company in satisfaction of its claims.

(vii) acquiring and holding and generally dealing with any property or any right, title or interest in such property which may form the security for any loans and advances.

(viii) underwriting and executing trusts.

(ix) establishing and supporting or aiding in the establishment and support of institutions, funds, trusts etc.

(x) acquisition, construction, maintenance and alteration of any building and works necessary for the purpose of the banking company.

(xi) selling, improving, managing, developing, or otherwise dealing with property and rights of the company.

(xii) acquiring and undertaking whole or any part of the business of any person or company.

(xiii) doing all such other things as are incidental or conductive to the promotion or advancement of the business of the banking company.

(xiv) any other business which the Central Government may specify.

No banking company shall engage in any form of business other than those referred to above.

To summarise all the above, the functions of Commercial Bank are:

Functions of a Commercial Bank

Some of the main functions of modern commercial banks are:

(a) Receiving of money on deposit and providing facilities to constituents for payments by cheque.

(b) Dealing in securities on its own account and on account of customers.

(c) Lending of money by -

(i) making loans and advances,

(ii) purchasing or discounting of bills.

(d) Transferring money from place to place by -

(i) the issue of demand drafts, telegraphic transfers, traveller's cheques, etc.,

(ii) collection of bills.

(e) Issuing letters of credit.

(f) Safe custody of securities and valuables.

(g) Issuing guarantees.

(h) Acting as executors and trustees sometimes through subsidiary companies formed for that purpose.

(i) Buying, selling and dealing in foreign exchange.

(j) Acting as managers for issue of capital by companies and performing functions incidental thereto.

1.2 Prohibition of Trading (Section 8)

A banking company cannot directly or indirectly deal in the buying or selling or bartering of goods except in connection with the realization of security given to or held by it . However, it may buy, sell or barter goods in connection with the bills of exchange received for collection or negotiation

1.3 Disposal of Non-Banking Assets (Section 9)

A banking co in the course of its business may have to take possession of certain asset charged in its favour on account of the failure of a debtor to repay the loan. A banking company can only acquire immovable property for its own use.–However, other immovable properties acquired must be disposed off within seven years from the date of acquisition. The Reserve Bank of India at its discretion can extend this. Income/loss from such an asset has to be shown separately in the profit and loss account of the banking company. It must be noted that the banking company can retain immovable property if it is meant for the banks own use.

For Example-XYZ bank acquired car from one customer on 1st January, 2006 who defaulted in payment of dues as it was held as security. Such assets are non banking assets and bank needs to dispose of them within seven years i.e by the end of 31st December 2013.

1.4 Management (Section 10)

Management of a Bank comes under its Board of Directors.

Under section 10(a), not less than 51% of the total number of members of the board of directors of a banking company shall consist of persons having special knowledge or practical experience in one or more of the following fields:

1. Accountancy.
2. Agriculture and rural economy.
3. Banking.
4. Co-operation.
5. Economics.
6. Finance.
7. Law.
8. Small scale industry.

It is also required not less than two directors should have special knowledge or practical experience in respect of agriculture and rural economy and co-operation or small-scale industry.

Under section 10(*b*)(1), every banking company shall have one of its directors as Chairman of its board of directors. The Chairman is entrusted with the management of the whole of the affairs of the banking company. Such Chairman is the whole-time employee of the banking company and can hold office for a period not exceeding five years. Other directors who are whole-time directors can hold office continuously for a period not exceeding eight years.

1.5 Capital and Reserve

***Requirement as to minimum paid-up capital and reserve (Section 11)*:**

- In the case of a banking company incorporated outside India and having a place or places of business in the city of Bombay or Calcutta or both, the aggregate value of its paid-up capital and reserve shall not be less than ₹ 20 lacs.
- Any banking company incorporated outside India and having a place or places of business in other cities shall have aggregate value of paid-up capital and reserves amounting to ₹ 15 lacs or more.
- In case of any banking company incorporated in India having places of business in more than one State including any such place or places of business situated in the city of Bombay or Calcutta or both, the aggregate value of its paid-up capital and reserves shall not be less than ₹ 10 lacs.
- In case of a banking company incorporated in India and having all its places of business in one State and none of which is situated in the city of Bombay or Calcutta, the aggregate value of its paid-up capital and reserves shall be ₹ 1 lakh in respect of all its principal places of business plus ₹ 10,000 in respect of each of its other places of business situated in the same district in which it has its principal place of business plus ₹ 25,000 in respect of each place of business situated elsewhere in the State (however, such banking company does not need to maintain the aggregate value of paid-up capital and reserve more than ₹ 5 lacs).
- Any banking company incorporated outside India is required to deposit with the Reserve Bank either in cash or in the form of unencumbered approved securities or partly in cash and partly in securities, the minimum amount of paid-up capital and reserves which it has to maintain under section 11(2).

***Regulation relating to authorized capital, subscribed capital and paid-up capital (Section 12)*:** The subscribed capital of a banking company carrying on business in India shall not be less than one-half of the authorised capital and the paid-up capital shall not be less than one-half of the subscribed capital. The capital of the banking company consists of ordinary shares or equity shares and such preference shares which have been issued prior to the first day of July, 1944. The voting right of any single shareholder on a poll cannot exceed 10% of the total voting rights.

Under section 13 of the Banking Regulation Act a banking company cannot pay out directly or indirectly commission, brokerage, discount, or remuneration in respect of any shares issued by it, an amount exceeding two and one-half per cent of the paid-up value of such shares.

1.6 Reserve Funds (Section 17)

Every banking company incorporated in India is required to create a Reserve Fund and to **transfer at least 25% of its profit to the reserve fund**. The profit of the year as per the profit and loss account prepared under Section 29 is to be taken as base for the purpose of such transfer and transfer to reserve fund should be made before declaration of any dividend.

If any banking company makes any appropriation from the reserve fund or share premium account, it has to report to the Reserve Bank of India the reasons for such appropriation within 21 days.

Note: Students shall ensure that 25% of the profit earned during current year is transferred as Statutory Reserve even if the question is silent on the issue in the examination question.

1.7 Restriction as to Payment of Dividend

Before paying any dividend, a banking company has to **write off completely** all its capitalised expenses including preliminary expenses, organisation expenses, share-selling commission, brokerage, and amounts of losses incurred by tangible assets. However, a banking company may pay dividend on its shares without writing off -

1. the depreciation in the value of its investment in approved securities in any case where such depreciation has not actually been capitalised or accounted for as a loss.
2. the depreciation in the value of its investment in shares, debentures or bonds (other than approved securities) in any case where adequate provision for such depreciation has been made to the satisfaction of the auditor of the banking company.
3. the bad debts in any case where adequate provision for such debts had been made to the satisfaction of the auditor of the banking company.

1.8 Cash Reserve (Section 18)

For smoothly meeting cash payment requirement, banks have to maintain certain minimum ready cash balances at all times. This is called as Cash Reserve Ratio (CRR)

Cash reserve can be maintained by way of either a cash reserve with itself or as balance in a current account with the Reserve Bank of India or by way of net balance in current accounts.

Every Scheduled Commercial Bank has to maintain cash reserve ratio (i.e. CRR) as per direction of the RBI issued under Section 42(IA) of the Reserve Bank of India Act, 1934.

The current Cash Reserve Ratio (CRR) is 4% of their Net Demand and Time Liabilities (NDTL) with effect from the fortnight beginning February 09, 2013 vide circular DBOD.No.Ret.BC.76 /12.01.001/2012-13 dated January 29, 2013. The Local Area Banks shall also maintain CRR at 4.00 per cent of its net demand and time liabilities from the fortnight beginning from February 09, 2013.

Demand and Time Liabilities

Demand Liabilities of a bank are liabilities which are payable on demand. These include current deposits, demand liabilities portion of savings bank deposits, margins held against letters of credit/guarantees, balances in overdue fixed deposits, cash certificates and cumulative/recurring deposits, outstanding Telegraphic Transfers (TTs), Mail Transfers (MTs), Demand Drafts (DDs), unclaimed deposits, credit balances in the Cash Credit account and deposits held as security for advances which are payable on demand. Money at Call and Short Notice from outside the Banking System should be shown against liability to others.

Time Liabilities of a bank are those which are payable otherwise than on demand. These include fixed deposits, cash certificates, cumulative and recurring deposits, time liabilities portion of savings bank deposits, staff security deposits, margin held against letters of credit, if not payable on demand, deposits held as securities for advances which are not payable on demand and Gold deposits.

Other Demand and Time Liabilities (ODTL)

ODTL include interest accrued on deposits, bills payable, unpaid dividends, suspense account balances representing amounts due to other banks or public, net credit balances in branch adjustment account, any amounts due to the banking system which are not in the nature of deposits or borrowing. Such liabilities may arise due to items like (i) collection of bills on behalf of other banks, (ii) interest due to other banks and so on. If a bank cannot segregate the liabilities to the banking system, from the total of ODTL, the entire ODTL may be shown against item II (c) 'Other Demand and Time Liabilities' of the return in Form 'A' and average CRR maintained on it by all SCBs .

Participation Certificates issued to other banks, the balances outstanding in the blocked account pertaining to segregated outstanding credit entries for more than 5 years in inter-branch adjustment account, the margin money on bills purchased / discounted and gold borrowed by banks from abroad, also should be included in ODTL.

Cash collaterals received under collateralized derivative transactions should be included in the bank's DTL/NDTL for the purpose of reserve requirements as these are in the nature of 'outside liabilities'.

1.9 Licensing of Banking Companies (Section 22)

A banking company can function in India only if it holds a licence issued by the Reserve Bank of India and included in the Second Schedule of the RBI Act. Before granting any licence, the Reserve Bank of India has to be satisfied that the following conditions have been complied with:

Financial Requirement:

The initial minimum paid-up capital for a new bank shall be ₹ 200 crore. The initial capital will be raised to ₹ 300 crore within three years of commencement of business. The overall capital structure of the proposed bank including the authorised capital shall be approved by the RBI.

Other Requirement:

In addition to the financial requirement the Reserve Bank of India would need to satisfy about the other additional requirements:

(a) That the company is or will be in a position to pay its present or future depositors in full as their claims accrue.

(b) That the affairs of the company are not being conducted or are not likely to be conducted in a manner detrimental to the interest of its present or future depositors.

(c) That the general character of the proposed management of the company will not be prejudicial to the public interest of its present or future depositors.

(d) That the company has adequate capital structure and earning prospects.

(e) That the public interest will be served by the grant of a licence to the company to carry on banking business in India.

(f) That having regard to the banking facilities available in the proposed principal area of banks already in existence in the area and other relevant factors, the grant of the licence would not be prejudicial to the operation and consolidation of the banking system consistent with monetary stability and economic growth.

Similarly, prior permission of the Reserve Bank of India is necessary to open a new branch of bank in India or to change the existing place of business situated in India. Also, no banking company incorporated in India can open a branch outside India or change the existing place of business without prior permission of the Reserve Bank of India.

1.10 Liquidity Norms (Section 24)

Banking companies have to maintain sufficient liquid assets in the normal course of business called as Statutory Liquidity Ratio (SLR). This safeguards the interest of depositors and prevents banks from over-extending their resources, liquidity norms have been settled and given statutory recognition. Every banking company has to maintain the SLR in the form of:

1. cash
2. gold
3. unencumbered approved securities.

The above assets have to be held at the close of business on any day and shall be valued at a price not exceeding the current market price of the above assets. At present, SLR should not be less than ***21.5%***• of its demand and time liabilities in India. However, this percentage is changed by the Reserve Bank of India from time to time considering the general economic conditions. This is in addition to the Cash Reserve Ratio balance which a scheduled bank is required to maintain under Section 42 of the Reserve Bank of India Act.

1.11 Restriction on Acquisition of Shares in Other Company

A banking company **cannot form any subsidiary** except for one or more of the following purposes:

1. The undertaking of any business permissible for banking company to undertake.

• ***RBI revises this rate time to time. The present SLR is as per Notification No. DBOD. No. Ret. BC. 70./12.02.001/2014.15 dated February, 3, 2015.***

2. Carrying on business of banking, exclusively outside India with previous permission in writing, of the Reserve Bank.
3. The undertaking of such other business which the Reserve Bank of India may permit with prior approval of the Central Government.

Other than formation of such subsidiary companies as mentioned above, a banking company cannot hold shares in any company either as pledge, mortgage, or absolute owner of an amount not exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

1.12 Restriction on Loans and Advances

Under Section 20 of the Banking Regulations Act, a banking company shall not grant any loans or advances on the security of its own shares. Further, it cannot enter into any commitment for granting any loan or advance to or on behalf of -

(i) any of its directors.

(ii) any firm in which any of its directors is interested as partner, manager, employee or guarantor.

(iii) any company other than the subsidiary of the banking company, or a company which is entitled to dispense with the use of the word Ltd in its name under the Companies Act, or a Government company of which any of the directors of the banking company is a director, manager, employee or guarantor or in which he holds substantial interest.

(iv) any individual in respect of whom any of its directors is a partner or a guarantor.

1.13 Prohibition of Charge on Unpaid Capital and Floating Charge on Assets

Under Section 14 of the Banking Regulation Act, no banking company shall create any charge upon any unpaid capital of the company, and any charge if created shall be invalid. A banking company also cannot create a floating charge on the undertaking or any property of the company or any part thereof unless the creation of such floating charge is certified in writing by the Reserve Bank as not being detrimental to the interest of the depositors of such company (Section 14A). Any charge created without obtaining the certificate from the RBI as above shall be invalid (Sec 14 A (2).

1.14 Unclaimed Deposits

Under Section 26 of the Banking Regulations Act, every banking company is required to submit a return in the prescribed form and manner, to the Reserve Bank of India at the end of each calendar year, of all accounts in India which have not beeen operated for 10 years. This report is to be submitted within 30 days after the close of each calendar year. In case of fixed deposit, such 10 years are to be reckoned from the date of expiry of the fixed deposit period.

1.15 Accounts and Audit

Sections 29 to 34A of the Banking Regulation Act deal with accounts and audit of Banking Companies. At the end of each calendar year or at the expiration of twelve months ending on such date as the Central Government may specify in this regard, every banking company incorporated in India, in respect of business transacted by it, and every banking company incorporated outside India, in respect of business transacted by its branches in India, shall prepare with reference to that year or period, a Balance Sheet (Form A) and Profit and Loss Account (Form B) as on the last working day of that year or the period in the forms set out in the Third Schedule of Banking Regulation Act.

The Balance Sheet and the Profit and Loss Account must be signed by the manager or principal officer and by at least three directors or all directors if there are not more than three directors in case of a banking company incorporated in India. In case of a banking company incorporated outside India, the statement of accounts must be signed by the manager or agent of the principal office of the company in India.

Under Section 30 of the Banking Regulation Act, the Balance Sheet and Profit and Loss Account prepared in accordance with Section 29 shall be audited by a person duly qualified under any law for the time being in force to be an auditor of companies. Every banking company is required to take previous approval of the Reserve Bank of India before appointing, re-appointing or removing any auditor or auditors. In addition, the Reserve Bank can order special audit of the banking companies accounts if it thinks fit in the public interest of the banking company or its depositors.

Unit – 2 : Books of Accounts, Returns and Forms of Financial Statements

Learning Objectives

After studying this unit, you will be able to:

- ♦ Learn the main characteristics of a bank's system of book keeping.
- ♦ Understand the methods in which all detailed accounts in subsidiary books and principal books are maintained by a bank and their purposes.
- ♦ Make a list of various other registers, departmental journals and memorandum books generally maintained by a bank.
- ♦ Familiarize with the monthly, quarterly and annual returns filed by a bank to the RBI.
- ♦ Appreciate the formats of Banks Financial Statements in Form A for Balance Sheet and Form B for Profit and Loss Statement of the Banking Regulation Act.

2.1 Main Characteristics of a Bank's Book-Keeping System

The book-keeping system of a banking company is substantially different from that of a trading or manufacturing enterprise. A bank maintains a large number of accounts of various types for its customers. As a safeguard against any payment being made in the account of a customer in excess of the amount standing to his credit or a cheque of a customer being dishonoured due to a mistake in the balance in his account, it is necessary that customers' accounts should be kept up-to-date and checked regularly. In many other mercantile enterprises, books of primary entry (*i.e.,* day books) are generally kept up-to- date while their ledgers including the general ledger and subsidiary ledgers for debtors, creditors etc. are written afterwards. However a bank cannot afford to ignore its ledgers, particularly those concerning the accounts of its customers and has to enter into the ledgers every transactions as soon as it takes place. In bank accounting, relatively less emphasis is placed on day books. These are merely treated as a means to an end-the end being to keep up-to-date detailed ledgers and to balance the trial balance everyday and to keep all control accounts in agreement with the detailed ledgers.

Presently most if not all of the Banks' accounting is done on Core Banking Solutions (CBS) wherein all accounts are maintained on huge servers with posting being effected instantly through vouchers, debit cards, internet banking etc.

The main characteristics of a bank's system of book-keeping are as follows:

(a) **Voucher posting** – Vouchers are nothing but loose leaves of journals or cash books on which transactions are recorded as they occur. Entries in the personal ledger are made directly from vouchers instead of being posted from the books of prime entry.

(b) **Voucher summary sheets** - The vouchers entered into different personal ledgers each day are summarised on summary sheets, totals of which are posted to the control accounts in the general ledger.

(c) **Daily trial balance** - The general ledger trial balance is extracted and agreed every- day.

(d) **Continuous checks** - All entries in the detailed personal ledgers and summary sheets are checked by persons other than those who have made the entries. A considerable force of such check is employed, with the general result that most clerical mistakes are detected before another day begins.

(e) **Control Accounts** - A trial balance of the detailed personal ledgers is prepared periodically, usually every two weeks, agreed with general ledger control accounts.

(f) **Double voucher system** - Two vouchers are prepared for every transaction not involving cash - one debit voucher and another credit voucher.

2.1.1 Slip (or Voucher) System of Ledger Posting

The bank has to ensure that customers (depositors) ledger accounts are up-to-date so that when a cheque is presented to the bank for payment, the bank can immediately decide whether to honour or dishonour the cheque. It is therefore necessary that transactions in the bank are immediately recorded or are updated online.

For this purpose slip system of ledger posting is adopted. Under this system entries are made in the (personal) accounts of customers in the ledger directly from various slips rather than from subsidiary books or journals and then a Day Book is written up. Subsequently, entries in the accounts of the customers are tallied with the Day Book. In this way the posting in the ledger accounts and writing of the day-book can be carried out simultaneously without any loss of time. A slip is also called voucher.

In general, the types of slips used in bank book-keeping are: pay-in-slips, cheques or withdrawal forms.

As these slips are filled by the customers there is much saving of time and labour of the employees of the bank.

(a) Pay-in-slip : When a customer deposits money with a bank, he has to fill-up a printed pay-in-slip form and submit it to the **'receiving cashier'** of the bank along with cash. The form of pay-in-slip has two parts. The left-hand side portion of the pay-in-slip is called **'counterfoil'.** It is returned by the receiving cashier after he receives and counts the cash. The counterfoil bears signature of the receiving cashier and it is duly stamped with the rubber stamp of the bank. Pay-in-slip serves as an acknowledgement of the deposit by the customer with the bank. The remaining portion of pay-in-slip that is, its right-hand-side part remains with the bank for making entry in the cash book, after which it is given to the 'personal accounts ledger keeper' for crediting the ledger account of the customer. However, with the advancement of banking through computerization, these days the cheques can be deposited merely by writing the account number of the depositor on the back of the cheque. Similarly cash can be deposited through ATMs (Automatic Teller Machines). In such cases, the documents used for entries are the cheques deposited and the deposit slips in the ATMs.

(b) Withdrawal slip or cheque: When a customer withdraws money from the bank, he has to fill-up or write a cheque or withdrawal form and submit it to the paying cashier who makes payment, after checking the signature of the customer and adequacy of amount in his ledger account. The paying cashier credits the cash account and the ledger-keeper debits the customer's account. These days the cashier may himself debit the customer's account in the computer based ledger immediately before making the payment.

(c) Dockets: Sometimes the bank staff also prepares slips for making entries in the ledger accounts for which there are no original vouchers. For example, the loan department of a bank prepares vouchers when the interest is due. This slip or voucher is known as docket.

2.1.2 Need of the Slip System

The need for slip system arises due to following reasons :

(i) Updated Accurate Accounts: The bank must keep its customers' accounts accurate and up-to-date because a customer may present a cheque or withdrawal slip anytime during business hours of the bank.

(ii) Division of Work: As the number of transactions in bank is very large, the slip system permits the distribution of work of posting simultaneously among many persons of the bank staff.

(iii) Smooth Flow of Work: The accounting work moves smoothly without any interruption.

However, as mentioned above these days due to complete computerization of the banking sector, pay in slips are not used in may banks.

2.2 Principal Books of Accounts

a) The General ledger contains accounts of all personal ledgers, the profit and loss account and different asset accounts. The accounts in the general ledger are arranged in such an order that a balance sheet can be readily prepared therefrom. There are certain additional accounts known as contra accounts which are a feature of bank accounting. These are kept with a view to keep control over transactions which have no direct effect on the bank's position *e.g.,* letters of credit opened, bills received or sent for collection, guarantees given, etc.

b) **Profit and loss ledger -** Some banks keep one account for profit and loss in the General Ledger and maintain separate books for the detailed accounts. These are columnar books having separate columns for each revenue or expense head. Other banks maintain separate books for debits and credits. These books are posted from vouchers. The total of debits and credits posted are entered into the Profit and Loss Account in the General Ledger. In some banks, the revenue accounts are also maintained in the General Ledger itself, while in some others broad revenue heads are kept in the General Ledger and their details are kept in subsidiary ledgers.

For management purposes the account heads in the Profit and Loss ledgers are more detailed than those shown in the published Profit and Loss Account of the bank. For example, there will be separate accounts for basic salary, dearness allowance and various other allowances, which are grouped together in the final accounts. Similarly, various accounts concerning general charges, interest paid, interest received, etc., are maintained separately in the Profit and Loss ledgers.

2.3 Subsidiary Books

(a) Personal Ledgers - Separate ledgers are maintained by a bank for different types of accounts. For example, there are separate ledgers for Current Accounts, Fixed Deposits (often further classified by length of period of deposit), Cash Certificates, Loans, Overdrafts, etc. As has been mentioned earlier, these ledgers are posted directly from vouchers, and all the vouchers entered in each ledger in a day are summarised into voucher summary sheets. The voucher summary sheets are prepared in the department which originates the transaction, by persons other than those who write the ledgers. They are subsequently checked with the vouchers by different persons generally unconnected with the writing up of ledgers on the Voucher Summary Sheets.

(b) Bill Registers - Details of different types of bills are kept in separate registers which have suitable columns. For example, bills purchased, inward bills for collection, outward bills for collection etc. are entered serially on day-to-day basis in separate registers. In case of bills purchased or discounted, party-wise details are also kept in normal ledger form. This is done to ensure that the sanctioned limits of parties are not exceeded.

Entries in these registers are made by reference to the original documents. A voucher for the total amount of the transaction of each day is prepared in respect of each register. This voucher is entered in the Day Book. When a bill is realised or returned, its original entry in the register is marked off. A daily summary of such realisations or returns is prepared in separate registers whose totals are taken to vouchers which are posted in the Day Book.

In respect of bills for collection, contra vouchers reflecting both sides of the transaction are prepared at the time of the original entry, and this is reversed on realisation.

Outstanding entries are summarised frequently, usually twice a month, and their total is agreed with the balance of the respective control accounts in the General Ledger.

2.4 Other Subsidiary Registers

There are different registers for various types of transactions. Their number, volume and details will differ according to the individual needs of each bank. For example, there will be registers for :-

(a) Demand Drafts, Telegraphic Transfers and Mail Transfers issued on Branches and Agencies.

(b) Demand drafts, Telegraphic Transfers and Mail Transfers received from Branches and Agencies.

(c) Letters of Credit.

(d) Letters of Guarantee.

Entries into these registers are made from original documents which are also summarized on vouchers everyday. These vouchers are posted into Day Book.

Outstanding entries are summarised frequently and their total agreed with the control heads in the General ledger.

2.5 Departmental Journals

Each department of the Bank maintains a journal to note the transfer entries passed by it. These journals are memoranda books only, as all the entries made there are also made in the Day Book through Voucher Summary Sheets. Their purpose is to maintain a record of all the transfer entries originated by each department. For example, the Loans and Overdraft Section will pass transfer entries for interest charged on various accounts every month, and as all these entries will be posted in the journal of that department, the office concerned can easily find out the accounts in respect of which the interest entry has been passed. Since all vouchers passed during the day are entered into the Day Book only in a summary form, it may not be possible to get this information from the Day Book without looking into the individual vouchers. Moreover, as the number of departments in banks is quite large, the Day Book may not be accessible at all times to all departments.

As has been mentioned earlier, two vouchers are generally made for each transaction by transfer entry, one for debit and the other for credit. The vouchers are generally made by and entered into the journal of the department which is affording credit to the other department. For example, if any amount is to be transferred from Current Account of a customer to his Saving Bank Account, the voucher will be prepared by the Current Accounts Department and entered in the journal of that department.

2.6 Other Memorandum Books

Besides the books mentioned above, various departments of the bank have to maintain a number of memoranda books to facilitate their work. Some of the important books are described below :-

a) Cash Department

(a) Receiving Cashiers' cash book

(b) Paying Cashiers' cash book

(c) Main cash book

(d) Cash Balance book

The main Cash Book is maintained by persons other than the cashiers. Each cashier keeps a separate cash book. When cash is received, it is accompanied by pay-in-slip or other similar document. The cashier makes the entry in his book which is checked by the chief cashier. The pay-in-slip then goes to the Main Cash Book writer who makes an entry in his books. The cash book checker checks the entry with the slip and then the counter-foil of the slip is returned back to the customer and the foil is sent to the appropriate department for entering into the ledger. The foil is used as a voucher. Cash is paid against a cheque or other document (e.g. traveller's cheque, demand draft, pay order, etc.) after it has been duly passed and entered in the appropriate account in the ledger. Cheques, demand drafts, pay orders, etc. are themselves used as vouchers.

b) Quick Payment System - Banks introduce different systems so that their customers may receive payment of cash etc. quickly. The most prevalent system is the teller system. Under this system tellers keep cash as well as ledger cards and the specimen signature cards of each customer in respect of Current and Saving Bank Accounts. A teller is authorised to make payment upto a particular amount, say, ₹ 10,000. On receipt of the cheque, he verifies it, passes it for payment, then enters it in the ledger card and makes the payment to customer. The teller also receives cash deposited in these accounts.

c) Outward Clearing: (i) A Clearing Cheque Received Book for entering cheques received from customers for clearing.

(ii) Bankwise list of the above cheques, one copy of which is sent to the Clearing House together with the cheques.

A person checks the vouchers (foil of pay-in slips) and lists with the Clearing Cheque Received Book. The vouchers are then sent to appropriate departments, where customers' accounts are immediately credited. If any cheque is received back unpaid the entry is reversed. Normally, no drawings are allowed against clearing cheques deposited on the same day but exceptions are often made by the manager in the case of established customers.

d) Inward Clearing - Cheques received are verified with the accompanying lists. They are then distributed to different departments and the number of cheques given to each department is noted in a Memo Book. When the cheques are passed and posted into ledgers, their number is independently agreed with the Memo Book. If any cheques are found unpayable, they are returned back to the Clearing House. The cheques themselves serve as vouchers.

e) Loans & Overdraft Departments

(a) Registers for shares and other securities held on behalf of each customer.

(b) Summary Books of Securities giving details of Government securities, shares of individual companies etc.

(c) Godown registers maintained by the godown-keeper of the bank.

(d) Price register giving the wholesale price of the commodities pledged with the bank.

(e) Overdraft Sanction register.

(f) Drawing Power book.

(g) Delivery Order books.

(h) Storage books.

f) Deposits Department

(a) Account Opening & Closing registers.

(b) For Fixed Deposits, Rate register giving analysis of deposits according to rates.

(c) Due Date Diary.

(d) Specimen signature book.

g) Establishment department

(a) Salary and allied registers, such as attendance register, leave register, overtime register, etc.

(b) Register of fixed assets, e.g., furnitures and fixtures, motor cars, vehicles, etc.

(c) Stationery registers.

(d) Old records register.

h) General

(a) Signature book of bank's officers.

(b) Private Telegraphic Code and Cyphers.

2.7 Statistical Books

Statistical records kept by different banks are in accordance with their individual needs. For example, there may be books for recording (*i*) average balance in loans and advances etc., (*ii*) Deposits received and amount paid out each month in the various departments, (*iii*) Number of cheques paid, (*iv*) Number of cheques, bills and other items collected.

The above is not an exhaustive list of accounting records kept by a bank.

2.8 Forms of Balance Sheet and Profit and Loss Account

The Committee under the Chairmanship of Shri A. Ghosh, Deputy Governor, RBI, after due deliberation suggested suitable changes/amendments in the forms of balance sheet and profit and loss account of banks, having regard to :

1. need for better disclosure
2. expansion of banking operations both area-wise and sector-wise over the period
3. need for improving the presentation of accounts etc.

The formats are given below as specified in Banking Regulation Act in Form A of Balance Sheet, Form B of Profit and Loss Account and eighteen other schedules of which the last two relates to Notes and Accounting Policies.

New Revised Formats
The Third Schedule
(See Section 29)

Form 'A'

Form of Balance Sheet

Balance Sheet of _______________________ (here enter name of the Banking company)

Balance Sheet as on 31st March (Year) (000's omitted)

	Schedule	As on 31.3.... (Current year)	As on 31.3...... (Previous year)
Capital & Liabilities			
Capital	1		
Reserve & Surplus	2		
Deposits	3		
Borrowings	4		
Other liabilities and provisions	5		
Total			
Assets			
Cash and balances with Reserve Bank of India	6		
Balance with banks and Money at call and short notice	7		
Investments	8		
Advances	9		
Fixed Assets	10		
Other Assets	11		
Total			
Contingent liabilities	12		
Bills for collection			

Refer Annexure I for detailed break up of the Balance Sheet schedules at the end of chapter

Form 'B'
Form of Profit & Loss Account
for the year ended 31st March

('000 omitted)

		Schedule	Year ended As on 31.3.... (Current year)	Year ended As on 31.3.... (Previous year)
I.	**Income**			
	Interest earned	13		
	Other income	14		
	Total			
II.	**Expenditure**			
	Interest expended	15		
	Operating expenses	16		
	Provisions and contingencies			
	Total			
III.	**Profit/Loss**			
	Net profit/loss (—) for the year			
	Profit/Loss (—) brought forward			
	Total			
IV.	**Appropriations**			
	Transfer to statutory reserves			
	Transfer to other reserves			
	Transfer to Government/Proposed dividends			
	Balance carried over to balance sheet			
	Total			

Refer Annexure II for detailed break up of the Profit and Loss Account schedules at the end of the chapter. Also detail guidelines of RBI for compilation of Financial Statements has been given in Annexure III.

Note: The Banking Regulations Act, 1949 prescribes Schedules 1 to 16 only. Any other schedule prepared by a Banking company besides what is specified in the Third schedule of the Banking Regulations Act, 1949, is only for better understanding of their financial statements. Accordingly, banks in addition to the above 16 schedules, may prepare Schedule 17 for Notes on Accounts and Schedule 18 for Disclosure of Accounting Policies.

2.9 Notes on Accounts

Capital adequacy ratio	The sum of Tier I and Tier II capital should be taken as the numerator while the denominator should be arrived at by converting the minimum capital charge for open exchange position stipulated by the Exchange Control Department of the 'notional risk assets' by multiplying it by 12.5 (the reciprocal of the minimum capital to risk-weighted assets ratio of 8%) and then adding the resulting figure to the weighted assets, compiled for credit risk purposes.
Capital adequacy ratio – Tier I Capital	Tier I capital should be taken as the numerator while the denominator should be arrived at by converting the minimum capital charge for open exchange position stipulated by the Exchange Control Department of the RBI into 'notional risk assets' by multiplying it by 25 (the reciprocal of the minimum capital to risk-weighted assets ratio of 4%) and then adding the resulting figure to the weighted assets, compiled for credit risk purposes.
Capital adequacy ratio-Tier II Capital Amount of subordinated debt raised as Tier II capital	This item should be shown by way of explanatory notes/remarks in the balance sheet as well as in Schedule 5 relating to 'Other Liabilities and Provisions'.
Percentage of shareholding of the Government of India in the nationalized banks	
Gross value of investments in India and outside India, the aggregate of provisions for depreciation separately on investments in India and outside India and the net value of investments in India and outside India	
Percentage of net NPAs to net advances	Net NPAs mean gross NPAs *minus* (balance in Interest Suspense Account *plus* ECGC claims received and held pending adjustment *plus* part payment received and kept in Suspense Account *plus* provisions held for loan losses).

Movements in NPAs	The disclosures should include the opening balances of Gross NPAs (after deducting provisions held, interest suspense account, ECGC claims received and part payments received and kept in suspense account) at the beginning of the year, reductions/additions to the NPAs during the year and the balances at the end of the year.
The amount of provisions made towards NPA, toward depreciation in the value of investments and the provisions towards tax during the year	These provisions along with other provisions and contingencies should tally with the aggregate of the amount held under 'Provisions and income-contingencies' in the profit and loss account.
Maturity pattern of investment securities	Banks may follow the maturity buckets prescribed in the guidelines on Assets-Liability Management System for disclosure of maturity pattern.
Maturity pattern of loans and advances	Banks may follow the maturity buckets prescribed in the guidelines on Assets-Liability Management System for disclosure of maturity pattern.
Foreign currency assets and liabilities	In respect of this item, the maturity profile of the bank's foreign currency liabilities should be given.
Maturity pattern of deposits	Banks may follow the maturity buckets prescribed in the guidelines on Asset-Liability Management System for disclosure of maturity pattern.
Maturity pattern of borrowings	Banks may follow the maturity buckets prescribed in the guidelines on Asset-Liability Management System for disclosure of maturity pattern.
Lending to sensitive sectors	Banks should disclose lending to sectors which are sensitive to asset price fluctuations. These should include advances to sectors such as capital market, estate, etc. and such other sectors to be defined as 'sensitive' by the RBI from time to time.
Interest income as a percentage to working funds	Working funds mean total assets as on the date of balance sheet (excluding accumulated losses, if any).
Non-interest income as a percentage to working funds	
Operating profit as a percentage to (interest working funds	Operating profit means total income minus expenses plus operating expenses etc.)

Return on assets	Return on assets means net profit divided by average of total assets as at the beginning and end of the year.
Business (deposits plus advances) per employee	This means fortnightly average of deposits (excluding inter-bank deposits) and advances divided by number of employees as on the date of balance sheet.

Profit per employee

Depreciation on Investments	As per RBI Circular, bank should make disclosure on the provision for depreciation on investments in the following formats. Opening Balance (as on April, 01) …………………… Add: Provisions made during the year: ………………. Less: Write-off/back of excess provisions during the year ……. Closing balance (as on March 31) ……………..
Corporate Debut Restructured Accounts	Banks should disclose in their published annual Balance Sheets, under "Notes on Accounts", the following information in respect of corporate debt restructuring undertaken during the year. a. Total amount of loan assets subjected to restructuring under CDR. [(a) = (b)+(c) +(d)] b. The amount of standard assets subjected to CDR. c. The amount of sub-standard assets subjected to CDR. d. The amount of doubtful assets subjected to CDR. Disclosures in the Notes on Account to the Balance Sheet pertaining to restructured / rescheduled accounts apply to all accounts restructured/rescheduled during the year. While banks should ensure that they comply with the minimum disclosures prescribed, they may make more disclosures than the minimum prescribed.
Non SLR Investment	Banks should make the following disclosures in the 'Notes on Accounts' of the balance sheet in respect of their non SLR investment portfolio.

Issuer Composition of Non SLR Investments

No.	Issuer	Amount	Extent of private placement	Extent of 'below investment grade' securities	Extent of 'unrated Securities	Extent of 'unlisted securities
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1.	PSUs					
2.	FIs					
3.	Banks					
4.	Private corporate					
5.	Subsidiaries/Joint Ventures					
6.	Others					
7.	Provision held towards depreciation		XXX	XXX	XXX	XXX
	Total					

Note:

1. Total under column 3 should tally with the total of investments included under the following categories in Schedule 8 to the balance sheet:
   a. Shares
   b. Debentures & Bonds
   c. Subsidiaries/Joint Ventures
   d. Others
2. Amounts reported under columns 4,5,6 and 7 above may not be mutually exclusive.

Non performing non-SLR investments

Particulars	Amount (₹ Crore)
Opening balance	
Additions during the year since 1st April	
Reductions during the above period	
Closing balance	
Total provisions held	

The bank should make appropriate disclosures in the "Notes on Account" to the annual financial statements in respect of the exposures where the bank had exceeded the prudential exposure limits during the year.

Notes and Instructions for Compilation

General instructions

1. Formats of Balance Sheet and Profit and Loss Account cover all items likely to appear in the statements. In case a bank does not have any particular item to report, it may be omitted from the formats.
2. Corresponding comparative figures for the previous year are to be disclosed as indicated in the format. The words "current year" and "previous year" used in the format are only to indicate the order of presentation and may appear in the accounts.
3. Figures should be rounded off to the nearest thousand rupees.
4. Unless otherwise indicated, the banks in these statements will include banking companies, nationalised banks, State Bank of India, Associate Banks and all other institutions including co-operatives carrying on the business of banking whether or not incorporated or operating in India.
5. The Hindi version of the balance sheet will be part of the annual report.

2.10 Disclosure of Accounting Policies

In order to bring the true financial position of banks to pointed focus and enable the users of financial statements to study and have a meaningful comparison of their positions, the banks should disclose the accounting policies regarding key areas of operation at one place along with notes on accounting in their financial statements. The RBI has taken several steps from time to time to enhance the transparency in the operations of banks by stipulating comprehensive disclosures in tune with international best practices. RBI has prescribed the following additional disclosures in the 'Notes to accounts' in the banks' balance sheets, from the year ending March, 2010:

(i) Concentration of Deposits, Advanced, Exposures and NPAs;

(ii) Sector-wise NPAs;

(iii) Movement of NPAs;

(iv) Overseas assets, NPAs and revenue;

(v) Off-balance sheet SPVs sponsored by banks.

Unit – 3 : Capital Adequacy Norms

Learning Objectives

After studying this unit, you will be able to understand

Definitions of capital funds (Tier I & Tier II)and minimum capital requirement,

Technique of computing weightage for the purpose of capital adequacy norms

3.1 Capital Framework of Banks Functioning in India

Capital adequacy is used to describe adequacy of capital resources of a bank in relation to the risks associated with its operations.

Capital Adequacy Ratio (CAR)

The Basel Committee on Banking Supervision had published the first Basel Capital Accord (popularly called as Basel I framework) in July, 1988 prescribing minimum capital adequacy requirements in banks for maintaining the soundness and stability of the International Banking System and to diminish existing source of competitive inequality among international banks. After Basel I framework, Basel II norms were released. The main objectives of Basel committee were:

(i) to stop reckless lending by bank

(ii) to strengthen the soundness and stability of the banking system and

(iii) to have a comparative footing of the banks of different countries.

With a view to adopting the Basle Committee on Banking Supervision (BCBS) framework on capital adequacy which takes into account the elements of credit risk in various types of assets in the balance sheet as well as off-balance sheet business and also to strengthen the capital base of banks, Reserve Bank of India decided in April 1992 to introduce a risk asset ratio system for banks (including foreign banks) in India as a capital adequacy measure. Having regard to the necessary upgradation of risk management framework as also capital efficiency likely to accrue to the banks by adoption of the advanced approaches envisaged under the Basel II Framework and the emerging international trend in this regard, in July 2009 it was considered desirable to lay down a timeframe for implementation of the advanced approaches in India.

Consequently, the Basel Committee on Banking Supervision (BCBS) released comprehensive reform package entitled "Basel III: A global regulatory framework for more resilient banks and banking systems" (known as Basel III capital regulations) in December 2010. Basel III reforms strengthen the bank-level i.e. micro prudential regulation, with the intention to raise the resilience of individual banking institutions in periods of stress. These new global regulatory and supervisory standards mainly seek to raise the quality and level of capital to ensure banks are better able to absorb losses on both a going concern and a gone concern basis, increase the risk coverage of the capital framework, introduce leverage ratio to serve as a backstop to the risk-based capital measure, raise the standards for the supervisory review process etc. Reserve Bank issued

Guidelines based on the Basel III reforms on capital regulation on May 2, 2012, to the extent applicable to banks operating in India. The Basel III capital regulation has been implemented from April 1, 2013 in India in phases and it will be fully implemented as on March 31, 2018.

***NOTE*: The capital adequacy norms given in this unit are as per existing Basel II norms. RBI requires Banks to maintain minimum capital risk adequacy ratio of 9 % on an ongoing basis*.**

Every bank should maintain a minimum capital adequacy ratio based on capital funds and risk assets. As per the prudential norms, all Indian scheduled commercial banks (excluding regional rural banks) as well as foreign banks operating in India are required to maintain capital adequacy ratio (or capital to Risk Weighted Assets Ratio) which is specified by RBI from time to time. At present capital adequacy ratio is 9%.

The capital adequacy ratio is worked out as below :

$$\frac{\text{Capital fund **}}{\text{Risk weighted assets } + \text{ off balance sheet items}} \text{ X } 100$$

** Capital Fund consists of Tier I & Tier II Capital

The CAR measures financial solvency of Indian and foreign banks. Under Basel II norms, Banks can lend only about 22 times of their core Capital.

3.2 Capital Funds

Capital is divided into two tiers according to the characteristics/qualities of each qualifying instrument. Tier I capital consists mainly of share capital and disclosed reserves and it is a bank's highest quality capital because it is fully available to cover losses.

Tier II capital on the other hand consists of certain reserves and certain types of subordinated debt. The loss absorption capacity of Tier II capital is lower than that of Tier I capital. When returns of the investors of the capital issues are counter guaranteed by the bank, such investments will not be considered as Tier I/II regulatory capital for the purpose of capital adequacy.

3.3 Tier-I and Tier-II Capital for Indian Banks

Tier I capital (also known are core capital) provides the most permanent and readily available support to a bank against unexpected losses.

---

* ***RBI has issued a master circular No. DBOD.No.BP.BC.5/21.06.001/2014/15 dated July 1, 2014 on "Prudential Guidelines on Capital Adequacy and Market Discipline- New Capital Adequacy Framework (NCAF)".***

3.3.1 Tier I capital

The elements of Tier I capital include

(i) Paid-up capital (ordinary shares), statutory reserves, and other disclosed free reserves, including share premium if any.

(ii) Perpetual Non-cumulative Preference Shares (PNCPS) eligible for inclusion as Tier I capital - subject to laws in force from time to time.

(iii) Innovative Perpetual Debt Instruments (IPDI) eligible for inclusion as Tier I capital, and

(iv) Capital reserves representing surplus arising out of sale proceeds of assets.

As reduced by :

- intangible assets.
- current and brought forward losses.
- Deferred Tax Asset (DTA)
- Creation of DTA results in an increase in Tier I capital of a bank without any tangible asset being added to the banks' balance sheet. Therefore, DTA, which is an intangible asset, should be deducted from Tier I capital.

3.3.2 Tier II capital: comprises elements that are less permanent in nature or are less readily available than those comprising Tier I capital. The elements comprising Tier II capital are as follows :

(a) Undisclosed reserves

(b) Revaluation reserves

(c) General provisions and loss reserves

(d) Hybrid debt capital instruments

(e) Subordinated debt

(f) Investment Reserve Account

(a) ***Undisclosed reserves and cumulative perpetual preference assets*** **-** These elements have the capacity to absorb unexpected losses and can be included in the capital, if they represent accumulations of post-tax profits and not encumbered by any known liability and should not be routinely used for absorbing normal loan or operating losses. Cumulative perpetual preference shares should be fully paid-up and should not contain clauses which permit redemption by the holder.

(b) ***Revaluation reserves*** **-** These reserves often serve as a cushion against unexpected losses but they are less permanent in nature and cannot be considered as core capital. Revaluation reserves arise from revaluation of assets that are under-valued in the bank's books. The extent to which the revaluation reserve can be relied upon as cushion for unexpected loss depends mainly upon the level of certainty that can be placed on estimates of the market values of the relevant assets, the subsequent proportion in values under difficult market conditions or in a forced sale, potential for actual liquidation at those values, tax consequences of revaluation etc. Therefore, it would be prudent to consider revaluation reserves at a discount of 55% while determining their value for inclusion in Tier-II capital. Such reserves however will have to be reflected on the face of the balance sheet as revaluation reserves.

(c) ***General provisions and loss reserves*** **-** If these are not attributable to the actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, they can be included in Tier-II capital. Adequate care must be taken to see that sufficient provisions have been made to meet all known losses and foreseeable potential losses before considering general provisions and loss reserves to be part of Tier-II capital. However, general provisions and loss reserves (including general provision on standard assets) may be taken only up to a maximum of 1.25 per cent of weighted risk assets.

'Floating Provisions' held by the banks, which is general in nature and not made against any identified assets, may be treated as a part of Tier II capital within the overall ceiling of 1.25 percent of total risk weighted assets.

Excess provisions which arise on sale of NPAs would be eligible Tier II capital subject to the overall ceiling of 1.25% of total Risk Weighted Assets.

(d) ***Hybrid Debt Capital instruments*** **-** Those instruments which have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, may be included in Tier II capital. At present the following instruments have been recognized and placed under this category:

i. Debt capital instruments eligible for inclusion as Upper Tier II capital ; and

ii. Perpetual Cumulative Preference Shares (PCPS) / Redeemable Non-Cumulative Preference Shares (RNCPS) / Redeemable Cumulative Preference Shares (RCPS) as part of Upper Tier II Capital.

(e) ***Subordinated Debt*** **-** To be eligible for inclusion in the Tier-II capital the instrument should be fully paid up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and should not be redeemable at the initiative of the holder or without the consent of the banks' supervisory authorities. They often carry a fixed maturity and as they approach maturity, they should be subjected to progressive discount for inclusion in Tier-II capital. Instrument with an initial maturity of less than five years or with a remaining maturity of one year should not be included as part of Tier-II capital. Subordinated debt instrument will be limited to 50% of Tier-I capital.

(f) ***Investment Reserve Account*** **-** In the event of provisions created on account of depreciation in the 'Available for Sale' or 'Held for Trading' categories being found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an Investment

Reserve Account in Schedule 2 –"Reserves & Surplus" under the head "Revenue and other Reserves" in the Balance Sheet and would be eligible for inclusion under Tier II capital within the overall ceiling of 1.25 per cent of total risk weighted assets prescribed for General Provisions/ Loss Reserves.

(g) Banks are allowed to include the 'General Provisions on Standard Assets' and 'provisions held for country exposures' in Tier II capital. However, the provisions on 'standard assets' together with other 'general provisions/ loss reserves' and 'provisions held for country exposures' will be admitted as Tier II capital up to a maximum of 1.25 per cent of the total risk-weighted assets.

3.3.3 Deductions from Tier I and Tier II Capital

a) Equity/non equity investments in subsidiaries

The investments of a bank in the equity as well as non-equity capital instruments issued by a subsidiary, which are reckoned towards its regulatory capital as per norms prescribed by the respective regulator, should be deducted at 50 per cent each, from Tier I and Tier II capital of the parent bank, while assessing the capital adequacy of the bank on 'solo' basis, under the Basel I Framework.

b) Credit Enhancements pertaining to Securitization of Standard Assets

i) **Treatment of First Loss Facility:** The first loss credit enhancement provided by the originator shall be reduced from capital funds and the deduction shall be capped at the amount of capital that the bank would have been required to hold for the full value of the assets, had they not been securitised. The deduction shall be made at 50% from Tier I and 50% from Tier II capital.

ii) **Treatment of Second Loss Facility:** The second loss credit enhancement provided by the originator shall be reduced from capital funds to the full extent. The deduction shall be made 50% from Tier I and 50% from Tier II capital.

iii) **Treatment of credit enhancements provided by third party:** In case, the bank is acting as a third party service provider, the first loss credit enhancement provided by it shall be reduced from capital to the full extent as indicated at para (i) above.

iv) **Underwriting by an originator** Securities issued by the SPVs and devolved / held by the banks in excess of 10 per cent of the original amount of issue, including secondary market purchases, shall be deducted 50% from Tier I capital and 50% from Tier II capital.

v) **Underwriting by third party service providers:** If the bank has underwritten securities issued by SPVs devolved and held by banks which are below investment grade the same will be deducted from capital at 50% from Tier I and 50% from Tier II.

3.4 Ratio of Tier II Capital to Tier I Capital

The quantum of Tier II capital is limited to a maximum of 100% of Tier I Capital. This seeks to ensure that the capital funds of a bank predominantly comprise of core capital rather than items of a less permanent nature. It may be clarified that the Tier II capital of a bank can exceed its Tier I capital; however, in such a case, the excess will be ignored for the purpose of computing the capital adequacy ratio.

3.5 Tier I and Tier II Capital for Foreign Banks

As in case of Indian banks, capital funds of foreign banks operating in India would also comprise of Tier I capital and Tier II capital.

Tier I capital of Foreign bank would comprise the following elements:

(i) Interest free funds from Head Office kept in a separate account in Indian books specifically for the purpose of meeting the capital adequacy norms.

(ii) Innovative Instruments eligible for inclusion as Tier I capital.

(iii) Statutory reserves kept in Indian books.

(iv) Remitable surplus retained in Indian books which is not repatriable so long as the bank functions in India.

Tier II Capital :

The elements of Tier II capital include the following elements.

a) Elements of Tier II capital as applicable to Indian banks.

b) Head Office (HO) borrowings raised in foreign currency (for inclusion in Upper Tier II Capital) subject to certain terms and conditions.

3.6 Risk-adjusted Assets

For CAR purposes the entire assets side of the Banks Balance Sheet is recalculated on the basis of assigning risk weights to each category of assets. This follows the principle of conservatism by considering assets at their Risk Adjusted Values rather than at their face value in calculating the CAR

For example, cash balances are not susceptible to any risks whereas advances are susceptible to credit risks. Even within advances, the risk of loss arising from failure of the customer to settle his obligation fully is less in the case of loans guaranteed by DICGC/ECGC as compared to unguaranteed loans.

Similarly, different off-balance sheet items also involve varying degree of risk. For example, the risk involved in guarantees given against counter-guarantees of other banks is much less compared to other guarantees. Similarly, guarantees related to particular transactions are less risky compared to general guarantees of indebtedness.

Recognising the above, the Reserve Bank has assigned different risk weights to different categories of assets. For example, cash, balances with Reserve Bank of India is assigned a risk weight of zero (i.e. the asset will not be considered to be at risk at all), loan and advances have generally been assigned a risk weight of 100 per cent.

The risk adjusted value for any category of assets is determined by multiplying the value of the category of an asset as per the balance sheet with the risk weight assigned thereto.

For example, if a bank has DICGC/ECGC guaranteed advances of ₹ 100 crores outstanding on the balance sheet date, the risk-adjusted value of these advances would be ₹ 50 crores (loans guaranteed by DICGC/ECGC have been assigned a risk weight of 50).

So even though the Bank has extended a loan of ₹ 100 crores, after Risk –Adjusted Assets, for CAR purposes it will be reckoned as only ₹ 50 Crores.

In brief the important weights for the purpose of Ascertainment of CAR are as follows:-

Sr. No.	Item of asset	Risk Weight %
1.	Cash, balances with RBI	0
2.	Balances in current account with other banks	20
3.	Investments in Government Securities	0
4.	Other Investments	100
5.	Loans & Advances guaranteed by Government	0
6.	Other Loans & Advances	100
7.	Bank Premises, Furniture & Fittings etc.	100
8.	All Off- Balance Sheet Items like LC's, LG's, Bills accepted.	100
9.	Non funded exposure to Real estate	150

For detailed Risk Weights as per RBI guidelines for the purpose of CAR are given in Annexure IV

3.7 Reporting for Capital Adequacy Norms

Banks should furnish an annual return. The format for the returns is specified by the RBI under Capital Adequacy Norms. The returns should be signed by two officials who are authorised to sign the statutory returns now being submitted to the Reserve Bank.

Illustration 1

A commercial bank has the following capital funds and assets. Segregate the capital funds into Tier I and Tier II capitals. Find out the risk-adjusted asset and risk weighted assets ratio –

Capital Funds:	*(Figures in ₹ lakhs)*
Equity Share Capital	*4,80,00*
Statutory Reserve	*2,80,00*
Capital Reserve (of which ₹ 280 lakhs were due to revaluation of assets and the balance due to sale)	*12,10*
Assets:	
Cash Balance with RBI	*4,80*
Balances with other Bank	*12,50*
Claims on Banks	*28,50*
Other Investments	*782,50*
Loans and Advances:	
(i) Guaranteed by government	*128,20*
(ii) Guaranteed by public sector undertakings of Government of India	*702,10*
(iii) Others	*52,02,50*
Premises, furniture and fixtures	*182,00*
Other Assets	*201,20*
Off-Balance Sheet Items:	
Acceptances, endorsements and letters of credit	*37,02,50*

Solution

(i) Capital Funds - Tier I :	*₹ in lakhs*	*₹ in lakhs*
Equity Share Capital		480,00
Statutory Reserve		280,00
Capital Reserve (arising out of sale of assets)		9,30
		769,30
Capital Funds - Tier II :		
Capital Reserve (arising out of revaluation of assets)	280	
Less : Discount to the extent of 55%	(154)	1,26
		770,56

(ii) Risk Adjusted Assets

Funded Risk Assets	₹ in lakhs	Percentage weight	Amount ₹ in lakhs
Cash Balance with RBI	4,80	0	—
Balances with other Banks	12,50	20	2,50
Claims on banks	28,50	20	5,70
Other Investments	782,50	100	782,50

Loans and Advances:			
(i) guaranteed by government	128,20	0	—
(ii) guaranteed by public sector undertakings of Central Govt.	702,10	0	—
(iii) Others	52,02,50	100	52,02,50
Premises, furniture and fixtures	1,82,00	100	1,82,00
Other Assets	2,01,20	100	2,01,20
			63,76,40
Off-Balance Sheet Item	*₹ in lakhs*	*Credit Conversion Factor*	
Acceptances, Endorsements and Letters of credit	37,02,50	100	37,02,50
			100,78,90

Risk Weighted Assets Ratio: $\frac{\text{Capital Funds (Tier I \& Tier II)}}{\text{Risk Adjusted Assets} + \text{off Balance sheet items}} \times 100$

$$= \frac{7{,}69{,}30 + 1{,}26}{63{,}76{,}40 + 37{,}02{,}50}$$

Capital Adequacy Ratio $= \frac{770{,}56}{100{,}78{,}90} \times 100 = 7.65\%$

Expected ratio is 9%. So the bank has to improve the ratio by introducing further Tier I capital.

Unit – 4 : Income Recognition, Classification of Assets and Provisions

Learning Objectives

In this unit, you will be able to:

- Determine the profit/loss of a bank which is determined by the income recognition policy. Learn the technique of income recognition followed by a bank.
- Classify advances of a Bank according to the riskiness i.e. standard assets, sub-standard assets, doubtful assets, and loss assets. Try to understand the definitions of various categories and also follow Illustration given in the chapter to learn.
- Create adequate provision against sub-standard, doubtful and loss assets. This helps to find out the bank profit in a conservative manner. Reserve Bank (RBI) has issued guidelines stating the rates to be followed for making such provision.
- Make provision for depreciation on their current investments. Learn how to classify investments into permanent and current and also follow the technique suggested by the Reserve Bank for computation of depreciation provision.

4.1 Income Recognition

Bulk of a banks' income is from two sources:-

1. Interest earned on Loans & Advances extended to its customers.
2. Discount and commission earned handling Bills of Exchange and Non-Funded advances like Letter of Credit (LC), Letter of Guarantee (LG) etc.

In this unit Income recognition from Loans & Advances will be dealt with and in the next unit Income from Bills/LCs'/LGs' will be taken up.

Income recognition for interest earned is a function of classification of the Bank loans & advances (i.e. its Assets into Performing & Non-Performing Assets (NPA's)). For Performing assets income is recognised as it is earned i.e. accrued. It is an essential condition for accrual of income that it should not be unreasonable to expect its ultimate collection. For Non Performing assets interest income is not considered on accrual basis and it is recognised only when it is actually received. Basically an NPA is a bad and doubtful debt.

An asset becomes non-performing when the bank does not receive income from it for a certain period. In concept, any credit facility (assets) becomes non-performing "when it ceases to generate income for a bank."

Note: Bank should classify an account as NPA if the interest due and charged during any quarter is not serviced fully within 90 days from the end of the quarter.

Income from non-performing assets can only be accounted for as and when it is actually received. The Accounting Standard 9 (AS 9) on 'Revenue Recognition' issued by the Institute of Chartered Accountants of India (ICAI) requires that the revenue that arises from the use, by others, of enterprise resources yielding interest should be recognized only when there is no significant uncertainty as to its measurability or collectability.

Illustration 1

Given below interest on advances of a commercial bank (₹ in lakhs)

	Performing Assets		*NPA*	
	Interest earned	*Interest received*	*Interest earned*	*Interest received*
Term Loans	*120*	*80*	*75*	*5*
Cash credits and overdrafts	*750*	*620*	*150*	*12*
Bills purchased and discounted	*150*	*150*	*100*	*20*

Find out the income to be recognized for the year ended 31st March, 2012.

Solution

Interest on performing assets should be recognised on accrual basis, but interest on NPA should be recognised on cash basis.

			₹ in lakhs
Interest on Term Loan :	(120 + 5)	=	125
Interest on cash credits and overdraft :	(750 + 12)	=	762
Income from bills purchased and discounted :	(150 + 20)	=	170
			1,057

Illustration 2

KC Bank Statement of interest on advances in respect of Performing assets and Non Performing Assets are as follows:-

(in lakhs)

	Performing Assets		*Non Performing Assets*	
	Interest earned	*Interest received*	*Interest earned*	*Interest received*
Cash credits and overdrafts	*1800*	*1060*	*450*	*70*
Term Loan	*480*	*320*	*300*	*40*
Bills purchased and discounted	*700*	*550*	*350*	*36*

Find out the income to be recognized for the year ended 31st March, 2012.

Solution

Interest on performing assets should be recognised on accrual basis, but interest on NPA should be recognised on cash basis.

			₹ in lakhs
Interest on cash credits and overdraft :	(1800+70)	=	1,870
Interest on Term Loan	(480+40)	=	520
Income from bills purchased and discounted :	(700+36)	=	736
			3,126

Illustration 3

Find out the income to be recognised in the case of SS Bank for the year ended 31st March, 2012:

(₹ in lakhs)

	Performing Assets		***Non-performing Assets***	
	Interest accrued	***Interest received***	***Interest accrued***	***Interest received***
Term loans	*240*	*160*	*150*	*10*
Cash credits and overdrafts	1,500	1,240	300	24

Solution

Calculation of interest income of SS Bank to be recognised for the year ended 31.3.2012

	(₹ in	*lacs)*
Term Loan		
Interest accrued on Performing Assets	240	
Interest received on Non - Performing Assets	10	250
Cash credit and overdraft		
Interest accrued on Performing Assets	1,500	
Interest received on Non - Performing Assets	24	1,524
Total interest to be recognised		1,774

Identification of NPA

The Reserve Bank of India has issued detailed guidelines to banks regarding the classification of advances between performing and non-performing assets which are revised from time to time. The latest guidelines for identifying an NPA's are:

1. **Bills purchased and discounted** become NPA if interest and / or instalment of principal remain overdue for a period exceeding 90 days.

2. **Term Loans:** become NPA if their amount (interest or principal) remain overdue wholly or partly for a period exceeding 90 days.

3. A cash credit / overdraft account is treated as NPA if it becomes out of order. An account is deemed to be out of order if the outstanding balance remains continuously in excess of the sanctioned borrowing power or though the outstanding balance remains below the sanctioned borrowing power, there have been no credits in the account for a continuous period of more than 90 days prior to the Balance Sheet date or where the credits have not been enough to cover the interest debited during the same period. Therefore, an account is treated as **'out of order'** if ***any*** of the following conditions are satisfied:

(a) The outstanding balance remains continuously in excess of the sanctioned limit/drawing power for a continuous period of 90 days prior to the Balance Sheet date

(b) Though the outstanding balance is less than the sanctioned limit/drawing power –

 (i) there have been no credits for a continuous period of more than 90 days prior to the date of balance sheet; or

 (ii) credits during the aforesaid period are not enough to cover the interest debited during the same period.

c) Further any amount due to the bank under any credit facility is 'overdue' if it is not paid on the due date fixed by the bank

Example of OUT OF ORDER

Sanctioned limit	₹60,00,000
Drawing power	₹55,00,000
Amount outstanding continuously from 1.01.2013 to 31.03.2013	₹ 47,00,000
Total interest debited	₹3,42,000
Total credits	₹1,25,000

Since the credit in the account is not sufficient to cover the interest debited during the period account will be said as NPA.

4. Agricultural Advances: Advances granted for agriculture purposes becomes NPA **if interest and/or installment of principal remains overdue for two crop seasons** in case of **short duration crops** and a loan granted for **long duration crops will be treated as NPA,** if the installment of principal or interest thereon remains **overdue for one crop season.** *Crops having crop season of more than one year i.e. upto the period of harvesting the crops raised will be termed as 'long duration" crops and other crops will be treated as "short duration" crops.*

5. Securitisation transactions: Such transactions become NPA when the amount of liquidity facility remains overdue for more than 90 days.

6. Derivative transactions: Such transactions become NPA when the overdue receivables representing positive mark to market value of a derivative contract remain unpaid for a period of 90 days from the specified due date for payment.

7. Government guaranteed advances: The credit facilities backed by guarantee of the Central Government though overdue may be treated as NPA only when the Government repudiates its guarantee when invoked. This exemption from classification of Government guaranteed advances as NPA is not for the purpose of recognition of income. The requirement of invocation of guarantee has been delinked for deciding the asset classification and provisioning requirements in respect of State Government guaranteed exposures. With effect from the year ending 31 March 2006 State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms if interest and/or principal or any other amount due to the bank remains overdue for more than 90 days.

8. Advances to Staff: As in the case of project finance, in respect of housing loans or similar advances granted to staff members where interest is payable after recovery of principal, the overdue status (in respect of payment of interest) should be reckoned from the date when there is default in payment of interest or repayment of instalment of principal on due date of payment.

9. Take-out Finance: In the case of take-out finance arrangement, the lending bank should apply the prudential norms in the usual manner so long as the account remains on its banks

* Take-out finance is a product emerging in the context of the funding of long-term infrastructure projects. Under this arrangement, the institution/bank financing the infrastructure projects ('the lending institution') has an arrangement with a financial institution ('the taking-over institution') for transferring to the latter the outstanding in respect of such financing on a pre-determined basis. There are several variants of take-out finance, but basically, they are either in the nature of unconditional take-out finance or conditional take-out finance. In the latter case, the taking-over institution stipulates certain conditions to be satisfied by the borrower before it is taken over from the lending institution. Thus, in this variant of take-over arrangements, there is an inherent element of uncertainty over the ultimate transfer of the outstanding amount to the taking-over institution. For a take-out finance arrangement to take effect, the borrower should also recognise the arrangement by way of inter-creditor arrangement.

10. Advances Guaranteed by EXIM Bank: In the case of advances covered under the guarantee-cum-refinance programme of EXIM Bank, to the extent payment has been received by the bank from the EXIM Bank, **the advance may not be treated as NPA. The balance should, however, be treated as NPA**. (if the conditions for treating it as NPA are satisfied).

11. Consortium Advances: Asset classification of accounts under consortium should be based on the **record of recovery of the individual member banks** and other aspects having a bearing on the recoverability of the advances. Where the remittances by the borrower under consortium lending arrangements are pooled with one bank and/or where the bank receiving remittances is not parting with the share of other member banks, the account will be treated as not serviced in the books of the other member banks and therefore, be treated as NPA. The banks participating in the consortium should, therefore, arrange to get their share of recovery transferred from the lead bank or get an express consent from the lead bank for the transfer of their share of recovery, to ensure proper asset classification in their respective books.

12. Advances Secured Against Certain Instruments: Advances secured against term deposits, national savings certificates (NSCs) eligible for surrender, Indira Vikas Patras, Kisan Vikas Patras and life insurance policies have been exempted from the above guidelines. Thus, interest on such advances may be taken to income account on due dates provided adequate margin is available in the respective accounts. Advances against gold ornaments, government securities and all other securities are not covered by this exemption.

4.1.1 Regularisation of Account by year-end: The identification of NPA is to be done on the basis of the position as on the balance sheet date. If an account has been regularised before the balance sheet date by payment of overdue amount through genuine sources (and not by sanction of additional facilities or transfer of funds between accounts), the account need not be treated as NPA. The bank should, however, ensure that the account remains in order subsequently. Also, a solitary credit entry made in the account on or before the balance sheet date which extinguished the overdue amount of interest or instalment of principal is not reckoned as the sole criterion for determining the status of the account as non-performing or otherwise.

Certain other important RBI guidelines with reference to NPA's are given below:-

(i) Temporary Deficiencies: The classification of an asset as NPA should be based on the record of recovery. Bank should not classify an advance account as NPA merely due to the existence of some deficiencies which are temporary in nature such as non-availability of adequate drawing power based on the latest available stock statement, balance outstanding exceeding the limit temporarily, non-submission of stock statements and non-renewal of the limits on the due date, etc. In the matter of classification of accounts with such deficiencies banks may follow the following guidelines:

a) Banks should ensure that drawings in the working capital accounts are covered by the adequacy of current assets, since current assets are first appropriated in times of distress. Drawing power is required to be arrived based on the stock statement which is current. However, considering the difficulties of large borrowers, stock statements relied upon by the banks for determining drawing power should not be older than three months. The outstanding in the account based on drawing power calculated from stock statements older than three months, would be deemed as irregular.

A working capital borrower account will become NPA if such irregular drawings are permitted in the account for a continuous period of 90 days even though the unit may be working or the borrower's financial position is satisfactory.

b) Regular and ad hoc credit limits need to be reviewed/ regularised not later than three months from the due date/date of ad hoc sanction. In case of constraints such as non-availability of financial statements and other data from the borrowers, the branch should furnish evidence to show that renewal/ review of credit limits is already on and would be completed soon. In any case, delay beyond six months is not considered desirable as a general discipline. Hence, an account where the regular/ ad hoc credit limits have not been reviewed/ renewed within 180 days from the due date/ date of ad hoc sanction will be treated as NPA.

(ii) Net Worth of Borrower/Guarantor or Availability of Security: Since income recognition is based on recoveries from an advance account, net worth of borrower/guarantor should not be taken into account for the purpose of treating an advance as NPA or otherwise. Likewise, the availability of security is not relevant for determining whether an account is NPA or not (this is, however, subject to certain exceptions).

(iii) Determination of NPAs : Borrower-wise, Not Facility-wise: If any of the credit facilities granted to a borrower becomes non-performing, all the facilities granted to the borrower will have to be treated as NPA without any regard to performing status of other facilities.

(iv) Partial Recoveries in NPAs: Interest partly realised in NPAs can be taken to income. However, it should be ensured that the credits towards interest in the relevant accounts are not out of fresh/additional credits facilities sanctioned to borrowers concerned.

4.1.2 Interest Application : On an account turning NPA, banks should reverse the interest already charged and not collected by debiting Profit and Loss account, and stop further application of interest. However, banks may continue to record such accrued interest in a Memorandum account in their books. For the purpose of computing Gross Advances, interest recorded in the Memorandum account should not be taken into account.

In the account books of the bank, a customer's loan account is debited with the amount lent to him and the interest accrued thereon is also entered in the debit side of his account. This procedure is followed when the financial position of the customer is good and he will be in a position to return the money on maturity date; the journal entry is :

Debit : Customer's Loan Account

Credit: Interest Account

But if there is any doubt regarding customer's ability to pay, the debt becomes doubtful and the interest accrued on doubtful debts at the end of the accounting year should not be credited to Interest Account because it remains unrealised and would artificially inflate the profit of the bank company. Interest on doubtful debts should be then credited to Interest Suspense Account and debited to Customer's Loan Account as shown below:

Debit : Customer's Loan Account

Credit : Interest Suspense Account

In the balance sheet Interest Suspense Account will be shown in Liabilities side of to be included in **Schedule 5: Other Liabilities and Provisions,** Customer's Loan account with interest included would be shown in the Assets side. At a later date when the loan is repaid by the customer and interest realised, the entry would be:

Debit : Interest Suspense Account

Credit: Interest Account

Finally, the unrealised amount of interest should be transferred to Customer's Loan Account with the help of following entry:

Interest Suspense Account Dr.

To Customer's Loan Account

For Example:

On 31 March 2013, there is an unsecured loan of ₹ 8,00,000 to Shri Pankaj in the loan ledger of a Sona Bank. It is found on enquiry that the financial position of the borrower is bad and doubtful. Interest on the said loan has accrued ₹ 80,000 and is yet to be recorded. During 2013-14, the bank is able to realise only 80% of the outstanding amount on account of customer's bankruptcy. Show how the transactions would be recorded in the books of the Sona bank.

Solution

Journal Entries
Books of Sona Bank

Date	Particulars		Debit ₹	Credit ₹
2013 31 March	Pankaj Loan Account	Dr.	80,000	
	To Interest Suspense Account			80,000
	(Interest due on doubtful debt credited to interest suspense account)			
2013-14	Bank Account	Dr.	7,04,000	
	To Pankaj Loan Account			7,04,000
	(Recovery of 80% of the total loan amount and interest accrued i.e. (8,00,000+80,000)			
	Interest Suspense Account	Dr.	64,000	
	To Interest Account			64,000
	(Amount received against the suspense account)			
	Interest Suspense Account	Dr.	16,000	
	Bad Debts Account	Dr.	1,60,000	
	To Pankaj Loan Account			1,76,000
	(Unrecovered portion of the interest reversed and the balance transferred to bad debts account)			

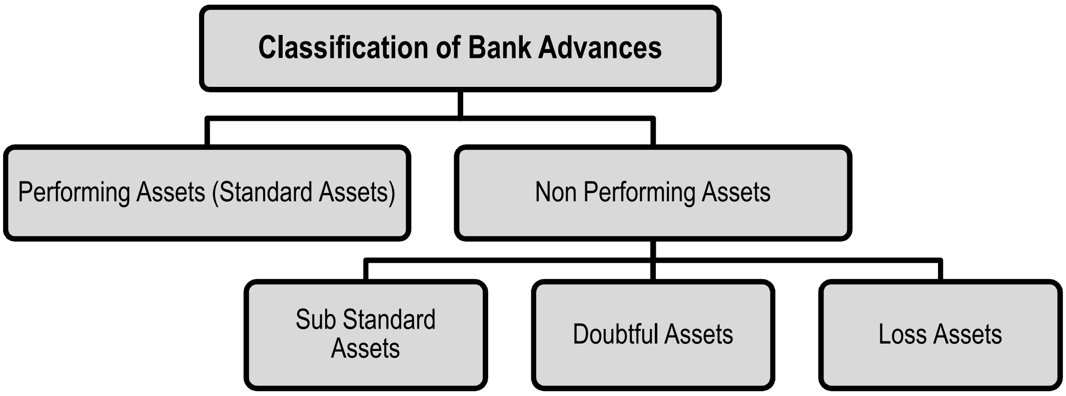
Treatment of interest suspense account: Amounts held in Interest Suspense Account should not be reckoned as part of provisions for NPA. Amounts lying in the Interest Suspense Account should be deducted from the relative advances and thereafter NPA, provisioning as per the norms, should be made on the balances after such deduction.

4.2 Classification of Bank Advances on basis of Performance

The Banks have to classify their advances into two broad groups:

1. Performing Assets
2. Non Performing Assets

Performing assets are also called as Standard Assets. The Non Performing Assets is again classified into three groups and they are (i) sub standard Assets (ii) doubtful assets & (iii) Loss Assets.



Performing Assets:

Standard Assets - Standard assets are those which do not disclose any problems and which does not carry more than normal risk attached to the business.

Non Performing Assets (NPA):

(i) **Sub-standard Assets** – A Sub-standard asset is one which has been classified as an NPA for a period not exceeding 12 months.

In such cases, the current net worth of the borrower/guarantor or the current market value of the security charged is not enough to ensure recovery of the dues to the bank in full. In other words, such an asset will have well-defined credit weaknesses that jeopardise the repayment of the debt and are characterised by the possibility that the bank would sustain some loss, if deficiencies are not corrected.

(ii) **Doubtful Assets** - An asset would be classified as doubtful if it has remained in the sub-standard category for a period of at least12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub standard, with the added characteristic that the weaknesses make collection or liquidation in full, questionable.

As per RBI guideline, loan upon becoming an NPA would first be classified as sub standard for a period not exceeding 12 months and beyond that it would have to be classified as DOUBTFUL.

(iii) **Loss Assets** - A loss asset is one where loss has been identified by the **bank or internal or external auditors or the RBI inspectors** but the amount has not been written off, wholly or partly. In other words, such an asset is considered uncollectible or if collected of such little value that its continuance as a bank asset is not warranted although there may be some salvage or recovery value.

It may be noted that the above classification is meant for the purpose of computing the amount of provision to be made in respect of advances and not for the purpose of presentation of advances in the balance sheet. The balance sheet presentation of advances is governed by the Third Schedule to the Banking Regulation Act, 1949, which requires classification of advances altogether differently.

Important Points for Provisions:

1. Threats to Recovery: As per the guidelines, upon becoming NPA, a credit facility would be classified first as sub-standard for a period not exceeding 12 months and then as doubtful. It has been clarified, however, that in respect of accounts where there are potential threats to recovery on account of erosion in the value of security or non-availability of security and existence of other factors such as frauds committed by borrowers, it will not be prudent for banks to clarify them first as sub-standard and thereafter as doubtful. Banks have been advised to classify such accounts **straightway** as doubtful or loss assets, as appropriate irrespective of the period for which the account has remained NPA.

2. Security having Significant Realisable Value: It has been clarified that where the realisable value of security is significant, the credit facility should not be treated as loss assets.

To illustrate, suppose, as on March 31, 2012, the bank or the internal/external auditor or the RBI *inspectors* identifies a particular credit facility as a loss asset where the amount outstanding is ₹ 100 lakh and the salvage value of the security is ₹ 10 lakh. In such a case, the facility should be treated as a loss asset and provision should be made for ₹ 100 lakh (and not ₹ 90.00 lakh). If, on the other hand, the realisable value of the security is ₹ 80 lakh (i.e) the realisable value of security is significant then the bank can treat the credit facility only as doubtful and not as a loss asset.

3. Reschedulement / Restructuring /Renegotiation of Advances: Banks may restructure the accounts classified under 'standard', 'sub-standard' and 'doubtful' categories. However, Banks can not reschedule / restructure /renegotiate any of the borrowal accounts with retrospective effect. While a restructuring proposal is under consideration, the usual asset classification norms would continue to apply. The process of re- classification of an asset should not stop merely because restructuring proposal is under consideration. The asset classification status as on the date of approval of the restructured package by the competent authority would be relevant to decide the asset classification status of the account after restructuring / rescheduling / renegotiation.

No account will be taken up for restructuring by the banks unless the financial viability is established and there is a reasonable certainty of repayment from the borrower, as per the terms of restructuring package. The viability should be determined by the banks based on the acceptable viability benchmarks determined by them, which may be applied on a case-by-case basis.

The stages at which the restructuring/rescheduling/ renegotiation of the terms of loan agreement can take place are as under:

(a) Before commencement of commercial production/operation;

(b) After commencement of commercial production/operation but before the asset has been classified as sub standard; and

(c) After commencement of commercial production/operation and after the asset has been classified as sub standard or doubtful.

The accounts classified as 'standard assets' should be immediately reclassified as 'sub-standard assets' upon restructuring (except for in certain cases). The non-performing assets, upon restructuring, would continue to have the same asset classification as prior to restructuring and slip into further lower asset classification categories as per asset classification norms with reference to the pre-restructuring repayment schedule (except for in certain cases). Any additional finance may be treated as 'standard asset', up to a period of one year after the first interest/principal payment, whichever is earlier, falls due under the approved restructuring package. However, in case of accounts where the pre-restructuring facility was classified as "sub-standard" and "doubtful", interest income on the additional finance should be recognized on cash basis only. If the restructured asset does not qualify for upgradation at the end of the above specified one year period, the additional finance shall be placed in the same asset classification category as the restructured debt.

All restructured accounts which have been classified as non-performing assets upon restructuring, would be eligible for up-gradation to the 'standard' category after observation of 'satisfactory performance' during the 'specified period'. In case, however, satisfactory performance after the specified period is not evidenced, the asset classification of the restructured account would be governed as per the applicable prudential norms with reference to the pre-restructuring payment schedule.

While reviewing the prudential guidelines on restructuring of advances by banks/ financial institutions, Reserve Bank of India has decided the following*:

i) To enhance the provisioning requirement for restructured accounts classified as standard advances from the existing 2.00 per cent to 2.75 per cent in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract a provision of 2.75 per cent for the period covering moratorium and two years thereafter; and that

ii) Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2.75 per cent in the first year from the date of upgradation instead of the existing 2.00 per cent.

In accordance with the above, loans to projects under implementation, when restructured due to change in the date of commencement of commercial operations (DCCO) beyond the original DCCO as envisaged at the time of financial closure and classified as standard advances in terms of guidelines contained in RBI circular DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010, would attract higher provisioning at 2.75 per cent as against the present requirement of 2.00 per cent as per the details given below:

Infrastructure projects

Particulars	*Provisioning Requirement*
If the revised DCCO is within two years from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond two years and upto four years or three years from the original DCCO, as the case may be, depending upon the reasons for such delay (Ref.: DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010)	2.75 per cent – From the date of such restructuring till the revised DCCO or 2 years from the date of restructuring, whichever is later.

Non-infrastructure projects

Particulars	*Provisioning Requirement*
If the revised DCCO is within six months from the original DCCO prescribed at the time of financial closure	0.40 per cent
If the DCCO is extended beyond six months and upto one year from the original DCCO prescribed at the time of financial closure (Ref.:DBOD.No.BP.BC.85 /21.04.048/2009-10 dated March 31, 2010)	2.75 per cent – From the date of such restructuring for 2 years.

* vide circular no.DBOD.No.BP.BC.63/21.04.048/2012-13 dated November 26, 2012. These norms are applicable for all scheduled commercial banks excluding RRBs.

Circular no. DBOD.No.BP.BC.33/21.04.048/2014-15 dated 14 August, 2014, states that: revisions of the date of commencement of commercial operations (DCCO) and consequential shift in repayment schedule for equal or shorter duration (including the start date and end date of revised repayment schedule) will not be treated as restructuring provided that:

(a) The revised DCCO falls within the period of two years and one year from the original DCCO stipulated at the time of financial closure for infrastructure projects and non-infrastructure projects respectively; and

(b) All other terms and conditions of the loan remain unchanged.

4.3 Provisions

Taking into account the time lag between an asset becoming substandard/doubtful turning into loss asset, RBI has directed that bank should make provision against all assets (i.e) Loans & advances as follows:

Rates of Provisioning for Non-Performing Assets*

Standard Assets

(i) The bank requires to make a general provision for standard assets at the following rates for the funded outstanding on global loan portfolio basis. The general provision towards standard assets as per Master circular is as follows:

(1) direct advances to agricultural and Small and Micro Enterprises (SMEs) sectors at 0.25 per cent;

(2) advances to Commercial Real Estate (CRE) Sector at 1.00 per cent;

(3) Advances to Commercial Real Estate – Residential Housing Sector (CRE - RH) at 0.75 per cent;

(4) Housing loans extended at lesser rates – 2.00%. The provisioning on these assets would revert to 0.40 per cent after 1 year from the date on which the rates are reset at higher rates if the accounts remain 'standard';

(5) Restructured accounts classified as standard advances will attract a higher provision (as prescribed from time to time) in the first two years from the date of restructuring. In cases of moratorium on payment of interest/principal after restructuring, such advances will attract the prescribed higher provision for the period covering moratorium and two years thereafter.

Restructured accounts classified as non-performing advances, when upgraded to standard category will attract a higher provision (as prescribed from time to time) in the first year from the date of upgradation.

The above-mentioned higher provision on restructured standard advances (2.75 per cent as prescribed vide circular dated November 26, 2012) would increase to 5 per cent in respect of new restructured standard accounts (flow) with effect from June 1, 2013 and increase in a phased manner for the stock of restructured standard accounts as on May 31, 2013 as under:

3.50 per cent - with effect from March 31, 2014 (spread over the fourquarters of 2013-14)

4.25 per cent - with effect from March 31, 2015 (spread over the fourquarters of 2014-15)

5.00 per cent - - with effect from March 31, 2016 (spread over the four quarters of 2015-16)

(6) All other loans and advances not included above - 0.40%

***(ii)** It is clarified that the Medium Enterprises will attract 0.40% standard asset provisioning. The definition of the terms Micro Enterprises, Small Enterprises, and Medium Enterprises shall be in terms of Master Circular on Lending to Micro, Small & Medium Enterprises (MSME) Sector.*

***(iii)** While the provisions on individual portfolios are required to be calculated at the rates applicable to them, the excess or shortfall in the provisioning, vis-a-vis the position as on any previous date, should be determined on an aggregate basis.*

***(iv)** The provisions on standard assets should not be reckoned for arriving at net NPAs. The provisions towards Standard Assets need not be netted from gross advances but included as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions - Others' in Schedule 5 of the balance sheet.*

Rates of Provisioning for Sub- standard, Doubtful and Loss Advances are as follows:

Category of Advances	Revised Rate (%)
Sub- standard Advances	
• Secured Exposures	15
• Unsecured Exposures	25
• Unsecured Exposures in respect of Infrastructure loan accounts where certain safeguards such as escrow accounts are available.	20
Doubtful Advances – Unsecured Portion	100
Doubtful Advances – Secured Portion	
• For Doubtful upto 1 year	25
• For Doubtful > 1 year and upto 3 years	40
• For Doubtful > 3 years	100
Loss Advances	100

***Accounting and Provisioning Norms for Equipment Leasing Activity:** While the accounting and provisioning norms discussed above shall also apply in respect of equipment leasing activities. The bank should follow the Accounting Standard 19 on "Leases" in accounting for lease transactions.*

Note:

1. The provisions on standard assets should not be reckoned for arriving at net NPAs.

2. The provisions towards Standard Assets need not be netted from gross advances but shown separately as 'Contingent Provisions against Standard Assets' under 'Other Liabilities and Provisions' in Schedule 5 of the balance sheet.

****As per Master Circular DBOD.No.BP.BC.1/21.04.048/2014-15 dated July 1, 2014.***

General Note: Since no bank is likely to extend any loans or advances without adequate security, it is prudent to assume in the questions that even in the case of substandard or doubtful or loss assets, the same are secured unless the question specifically mentions otherwise.

Illustration 1

The outstanding amount (funded as well as unfunded) as on 31st March, 2013 was: ₹ 10,000. The realizable value of security of the same was ₹ 8,000.

Period for which the advance has remained in 'doubtful' category as on 31st March, 2013 was: 2.5 years.

Solution

Provisioning requirement:

As on…	*Asset Classification*	*Provisions on secured portion*		*Provisions on unsecured portion*		*Total (₹)*
		%	Amount	%	Amount	
31 March, 2013	Doubtful 1 to 3 years	40	3,200	100	2,000	5,200
31 March, 2014	Doubtful more than 3 years	100	8,000	100	2,000	10,000

Note: The secured portion of the outstanding loan is ₹ 8,000 and unsecured portion is ₹ 2,000.

Illustration 2

From the following information, find out the amount of provisions to be shown in the Profit and Loss Account of AG bank.

		₹ in lakhs
Assets		
Standard		*5000*
Sub-standard		*4000*
Doubtful	*: for one year*	*800*
	: for three years	*600*
	: for more than three years	*200*
Loss Assets		*1000*

Solution

Computation of provisions for AG Bank

Assets	*Amount ₹ in lakhs*	*% of provision*	*Provision ₹ in lakhs*
Standard	50,00	0.4	20
Substandard*	40,00	15	600
Doubtful for one year*	8,00	25	200
Doubtful for three years*	6,00	40	240
Doubtful for more than three years	2,00	100	200
Loss	10,00	100	1,000
Total Provision required			**2,260**

** All the marked sub-standard and doubtful assets are assumed as fully secured.*

Illustration 3

From the following information of AY Limited, compute the provisions to be made in the Profit and Loss account:

	₹ in lakhs
Assets	
Standard	*20,000*
Substandard	*16,000*
Doubtful	
For one year (secured)	*6,000*
For two years and three years (secured)	*4,000*
. *For more than three years (secured by mortgage of plant and machinery ₹ 600 lakhs)*	*2,000*
Loss Assets	*1,500*

Solution

Calculation of amount of provision to be made in the Profit and Loss Account

Classification of Assets	*Amount of Advances*	*% age of provision*	*Amount of provision*
	(₹ in lakhs)		*(₹ in lakhs)*
Standard assets	20,000	0.40	80
Sub-standard assets	16,000	15	2,400
Doubtful assets:			
For one year (secured)	6,000	25	1,500
For two to three years (secured)	4,000	40	1,600
For more than three years (unsecured)	1,400	100	1,400

(secured)	600	100	600
Non-recoverable assets (Loss assets)	1,500	100	1,500
Total provision required			**9,080**

4.3.1 Provisioning for advances covered by ECGC/DICGC guarantee

In the case of advances guaranteed by Export Credit Guarantee Corporation (ECGC), Deposit Insurance 7 Credit Guarantee Corporation (DICGC) provision is required to be made only for the balance amount of advance outstanding in excess of the amount guaranteed by the corporations. In case the bank also holds a security in respect of an advance guaranteed by ECGC/DICGC, the realisable value of the security should be deducted from the outstanding balance before the ECGC/DICGC guarantee is off-set. The Reserve Bank of India has also clarified that if the banks are following more stringent method of provisioning in respect of advances guaranteed by ECGC/DICGC, such banks may continue to do so.

The manner of determining the amount of provision in respect of ECGC/DICGC guaranteed advances in accordance with the above guidelines is illustrated below. (It may be noted that these illustrations are merely intended to facilitate understanding of the RBI guidelines; they have not been issued by the RBI.)

Illustration 4

Outstanding Balance	*₹ 4 lakhs*
ECGC Cover	*50%*
Period for which the advance has remained doubtful	*More than 3 years remained doubtful (as on March 31, 2013)*
Value of security held	*₹ 1.50 lakhs*

You are required to calculate provisions.

Solution

Provision required to be made as on 31.03.2013

Outstanding balance	₹ 4.00 lakhs
Less: Value of security held(Secured Portion)	(₹ 1.50 lakhs)
Unrealised balance	₹ 2.50 lakhs
Less: ECGC Cover (50% of unrealizable balance)	(₹ 1.25 lakhs)
Net unsecured balance	₹ 1.25 lakhs
Provision for unsecured portion of advance	₹ 1.25 lakhs (@ 100% of unsecured portion)
Provision for secured portion of advance	₹ 1.50 lakhs (@ 100% of the secured portion as advance has remained doubtful for over 3 years)
Total provision to be made	**₹ 2.75 lakhs**

Illustration 5

Outstanding Balance	*₹ 4 lakhs*
ECGC Cover	*50%*
Period for which the advance has remained doubtful	*More than 3 years remained doubtful (as on March 31, 2012)*
Value of security held (realizable value only 80%)	*₹ 1.50 lakhs*

You are required to calculate provisions as per applicable rates.

Solution

Provision required to be made as on 31.03.2012

Outstanding balance	₹ 4.00 lakhs
Less: Value of security held (80% of 1.5 lacs)	(₹ 1.20 lakhs)
Unrealised balance	₹ 2.80 lakhs
Less: ECGC Cover (50% of unrealizable balance)	(₹ 1.40 lakhs)
Net unsecured balance	₹ 1.40 lakhs
Provision for unsecured portion of advance	₹ 1.40 lakhs (@ 100% of unsecured portion)
Provision for secured portion of advance	₹ 1.20 lakhs (@ 100% of the secured portion)
Total provision to be made	₹ 2.60 lakhs

Illustration 6

In KR Bank, the doubtful assets (more than 3 years) as on 31.3.2012 is ₹ 1,000 lakhs. The value of security (including DICGC 100% cover of ₹ 100 lakhs) is ascertained at ₹ 500 lakhs. How much provision must be made in the books of the Bank towards doubtful assets?

Solution

	(₹ in lakhs)
Doubtful Assets (more than 3 years)	1,000
Less: Value of security (excluding DICGC cover)	(400)
	600
Less: DICGC cover	(100)
Unsecured portion	500
Provision:	
for unsecured portion @100%	500 lakhs
for secured portion @ 100%	400 lakhs
Total provision to be made in the books of KR Bank	900 lakhs

Illustration 7

A loan outstanding of ₹ 50,00,000 has DICGC cover. The loan guaranteed by DICGC is assigned a risk weight of 50%. What is the value of Risk-adjusted asset?

Solution

Loan outstanding	₹50,00,000
Guaranteed by DICGC – Risk weight	50%
Value of risk adjusted asset ₹.50,00,000 × 50% =	₹ 25,00,000

Principle for creation of floating provisions

The Master Circular dated July 1, 2013 on Income Recognition, Asset Classification and Provisioning Pertaining to Advances, requires the bank's board of directors to lay down a policy regarding the level to which the floating provisions can be created. The bank should hold floating provisions for 'advances' and 'investments' separately.

The floating provisions should not be used for making specific provisions as per the extant prudential guidelines in respect of nonperforming assets or for making regulatory provisions for standard assets. The floating provisions can be used only for contingencies under extraordinary circumstances for making specific provisions in impaired accounts after obtaining board's approval and with prior permission of RBI. The boards of the banks should lay down an approved policy as to what circumstances would be considered extraordinary.

In terms of the Agricultural Debt Waiver and Debt Relief Scheme, 2008, lending institutions shall neither claim from the Central Government, nor recover from the farmer, interest in excess of the principal amount, unapplied interest, penal interest, legal charges, inspection charges and miscellaneous charges, etc. All such interest/charges will be borne by the lending institutions. In view of the extraordinary circumstances in which the banks are required to bear such interest/charges, banks are allowed, as a one time measure, to utilise, at their discretion, the Floating Provisions held for 'advances' portfolio, only to the extent of meeting the interest / charges referred to above.

Floating provisions cannot be reversed by credit to the profit and loss account. They can only be utilised for making specific provisions in extraordinary circumstances as mentioned above. Until such utilisation, these provisions can be netted off from gross NPAs to arrive at disclosure of net NPAs. Alternatively, they can be treated as part of Tier II capital within the overall ceiling of 1.25 % of total risk weighted assets.

***Disclosures:** Banks should make comprehensive disclosures on floating provisions in the "notes on accounts" to the balance sheet on (a) opening balance in the floating provisions account, (b) the quantum of floating provisions made in the accounting year, (c) purpose and amount of draw down made during the accounting year, and (d) closing balance in the floating provisions account.*

***Write-off of NPAs:** Banks may write-off advances at Head Office level, even though the advances are still outstanding in the branch books. At the branch level, provision requirement as per classification norms shall be made and in respect of loss assets*

100% provision shall be made. There can be partial write off relating to the borrower's account in head office.

<u>Interest Suspense Account</u>: As mentioned earlier, the guidelines prohibit recognition of income on non-performing assets until it is actually realised. In order to comply with guidelines while ensuring at the same time that legal remedies against defaulting borrowers are not adversely affected and that proper control is exercised over non-performing advances, many banks adopted the practice of recording interest on non-performing advances to a separate account which is usually styled as 'Interest Suspense Account'. The balance in this account represents interest on non-performing advances debited to the respective borrowers' accounts in accordance with the terms of the agreement but not recognised as income. For purposes of balance sheet presentation, the gross advances portfolio is arrived at after deducting the credit balance in Interest Suspense Account from the total advances as per the ledgers. When the advances are identified as NPAs and banks chooses not to further debit the borrower in the manner aforesaid, the interest on contractual basis is to be computed and recorded as unapplied interest in the memoranda records.

The amounts held in Interest Suspense Account should not be reckoned as part of provisions for the purpose of computing the provision for NPAs. Amounts lying in the Interest Suspense Account should be deducted from the advances concerned and provisions should be made on the balances remaining after such deduction.

4.4 Classification of Investments

A unique feature of investments of a bank is that a large proportion of the investments is made in pursuance of the requirement to maintain a certain minimum level of liquid assets[1]. The directions issued by RBI from time to time affect the methods of classification of investments. The entire investment portfolio of a bank (including SLR securities and non- SLR securities) should be classified under three categories :

Held-to-Maturity, (HTM) : Securities acquired by banks with the intention to hold them upto maturity should be classified as 'held-to-maturity'. Investments under 'held-to-maturity' category should not exceed 25 per cent of the total investments of the bank though a bank can at its discretion hold less than the aforesaid percentage under this category. Certain securities specified in this behalf are not to be reckoned while applying the ceiling of 25 per cent in respect of 'held-to-maturity' securities.

In order to further develop the government securities market and enhance liquidity, it has been decided to bring down the ceiling on SLR securities under the HTM category from 24 per cent of NDTL to 22 per cent* in a graduated manner. Accordingly it is advised that: Banks are permitted to exceed the limit of 25 per cent of total investments under HTM

---

[1] To maintain SLR

category provided:

a. ***the excess comprises only of SLR securities, and***

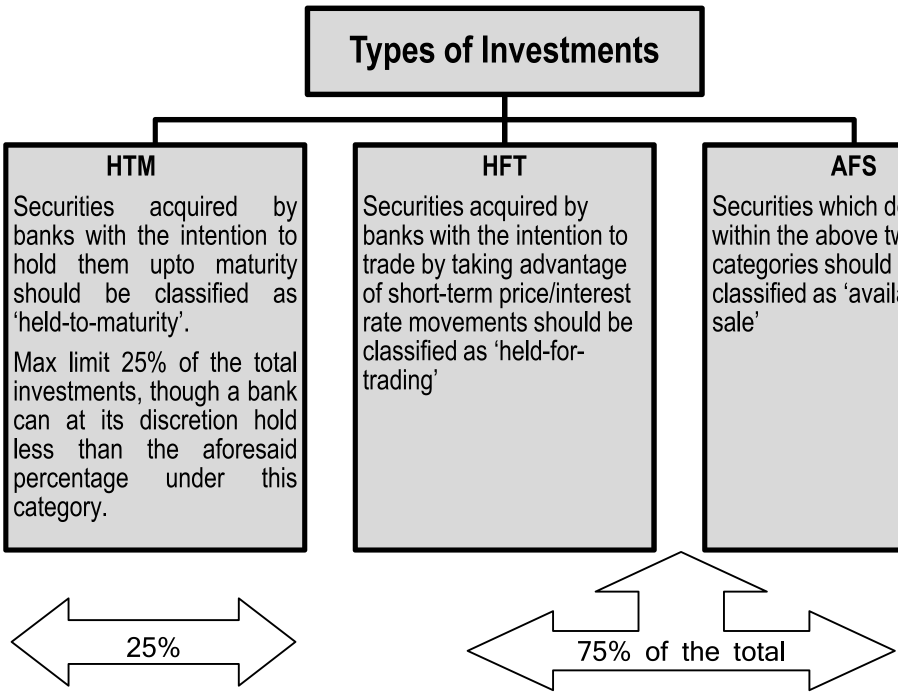
b. ***the total SLR securities held in the HTM category is not more than 23.50 per cent with effect from January 10, 2015, 23.0 per cent with effect from April 4, 2015, 22.5 per cent with effect from July 11, 2015 and 22.0 per cent with effect from September 19, 2015, of their DTL as on the last Friday of the second preceding fortnight.***

* ***As per DBOD.No.BP.BC.42/21.04.141/2014-15 dated 7 October, 2014***

Held-for-Trading. (HFT) : Securities acquired by banks with the intention to trade by taking advantage of short-term price/interest rate movements should be classified as 'held-for-trading'.

Available-for-Sale (AFS) : Securities which do not fall within the above two categories should be classified as 'available-for-sale'.

The banks will have the freedom to decide on the extent of holdings under HFT and AFS. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills or capital position. The investment classified under HFT would be those from which the bank expects to make again by the movement in the interest rates/market rates. These securities are to be sold within 90 days. Profit or loss on sale of investments in both the categories will be taken to the Profit and Loss Account.



4.5 Shifting among Categories of Investments

i) Banks may shift investments to/from HTM with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from HTM will be allowed during the remaining part of that accounting year.

ii) Banks may shift investments from AFS to HFT with the approval of their Board of Directors/ ALCO/ Investment Committee. In case of exigencies, such shifting may be done with the approval of the Chief Executive of the bank/Head of the ALCO, but should be ratified by the Board of Directors/ ALCO.

iii) Shifting of investments from HFT to AFS is generally not allowed. However, it will be permitted only under exceptional circumstances like not being able to sell the security within 90 days due to tight liquidity conditions, or extreme volatility, or market becoming unidirectional. Such transfer is permitted only with the approval of the Board of Directors/ ALCO/ Investment Committee.

iv) Transfer of scrips from AFS / HFT category to HTM category should be made at the lower of book value or market value. In other words, in cases where the market value is higher than the book value at the time of transfer, the appreciation should be ignored and the security should be transferred at the book value. In cases where the market value is less than the book value, the provision against depreciation held against this security (including the additional provision, if any, required based on valuation done on the date of transfer) should be adjusted to reduce the book value to the market value and the security should be transferred at the market value.

In the case of transfer of securities from HTM to AFS / HFT category,

(a) If the security was originally placed under the HTM category at a discount, it may be transferred to AFS / HFT category at the acquisition price / book value. (It may be noted that as per existing instructions banks are not allowed to accrue the discount on the securities held under HTM category and, therefore, such securities would continue to be held at the acquisition cost till maturity). After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.

(b) If the security was originally placed in the HTM category at a premium, it may be transferred to the AFS / HFT category at the amortised cost. After transfer, these securities should be immediately re-valued and resultant depreciation, if any, may be provided.

In the case of transfer of securities from AFS to HFT category or vice-versa, the securities need not be re-valued on the date of transfer and the provisions for the accumulated depreciation, if any, held may be transferred to the provisions for depreciation against the HFT securities and vice-versa.

4.6 Valuation of Investments

The Banks are required to classify investments into three categories:

(a) Held-to-Maturity,

(i) Investments classified under held-to-maturity category need not be marked to market. They should be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

(ii) The bank should reflect the amortised amount in Schedule 13: Interest Earned – Item II 'Income on Investments' as a deduction. However, the deduction need not be disclosed separately. The book value of the securities should continue to be reduced to the extent of the amount amortised during the relevant accounting period.

(iii) As per AS 13- only permanent diminution in the value of such investments under held-to-maturity category should be provided for. Such diminution should be determined and provided for each investment individually

(b) Available-for-sale: The individual scrips in the available-for-sale category should be marked to market quarterly or at more frequent intervals.

While the net depreciation under each of the categories (required by third schedule to Banking Regulation Act, 1949 – refer Unit 1) should be recognised and fully provided for, the net appreciation under any of the aforesaid categories above should be ignored. Thus, banks can offset gains in respect of some investments marked-to-market within a category against losses in respect of other investments marked-to-market in that category.

The guidelines however, do not permit offsetting of gains and losses across different categories. The book value of the individual securities would not have undergone any change after the marking to market . In other words, the depreciation or appreciation in value of individual scrips in accordance with the above methodology would not be credited to individual scrip accounts but would be held collectively in a separate account.

(c) Held-for-trading: The individual scrips in the 'held-for-trading' category should be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the 'Available for sale' category.

Consequently, the book value of the individual securities in this category would also not undergo any change after marking to market.

Banks are required to follow AS 13 'Accounting for Investments' issued by the ICAI relating to long-term investments for valuation of investments in subsidiaries. In terms of AS 13, long term investments should be arrived in the financial statements at carrying cost. However, provision for diminution shall be made to recognise a decline other than temporary, in the value of the investments, such reduction being determined and made for each investment individually.

4.7 Investment Fluctuation Reserve

(i) With a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, banks were advised to build up Investment Fluctuation Reserve (IFR) of a minimum 5 per cent of the investment portfolio within a period of 5 years.

(ii) To ensure smooth transition to Basel II norms, banks are advised to maintain capital charge for market risk in a phased manner over a two year period, as under:

(a) In respect of securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book , and

(b) In respect of securities included in the AFS category.

(iii) With a view to encourage banks for early compliance with the guidelines for maintenance of capital charge for market risks, banks which have maintained capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category may treat the balance in excess of 5 per cent of securities included under HFT and AFS categories, in the IFR, as Tier I capital. Banks satisfying the above were allowed to transfer the amount in excess of the said 5 per cent in the IFR to Statutory Reserve.

(iv) Banks maintaining capital of at least 9 per cent of the risk weighted assets for both credit risk and market risks for both HFT (items as indicated at (a) above) and AFS category would be permitted to treat the entire balance in the IFR as Tier I capital. For this purpose, banks may transfer the balance in the Investment Fluctuation Reserve 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account.

Investment Reserve Account (IRA)

(v) In the event, provisions created on account of depreciation in the 'AFS' or 'HFT' categories are found to be in excess of the required amount in any year, the excess should be credited to the Profit & Loss account and an equivalent amount (net of taxes, if any and net of transfer to Statutory Reserves as applicable to such excess provision) should be appropriated to an IRA Account in Schedule 2 – "Reserves & Surplus" under the head "Revenue and other Reserves", and would be eligible for inclusion under Tier-II within the overall ceiling of 1.25 per cent of total Risk Weighted Assets prescribed for General Provisions/ Loss Reserves.

(vi) Banks may utilise IRA as follows:

The provisions required to be created on account of depreciation in the AFS and HFT categories should be debited to the P&L Account and an equivalent amount (net of tax benefit, if any, and net of consequent reduction in the transfer to Statutory Reserve), may be transferred from the IRA to the P&L Account.

Illustratively, banks may draw down from the IRA to the extent of provision made during the year towards depreciation in investment in AFS and HFT categories (net of taxes, if any, and net of transfer to Statutory Reserves as applicable to such excess provision). In other words, a bank which pays a tax of 30% and should appropriate 25% of the net profits to Statutory Reserves, can draw down ₹52.50 from the IRA, if the provision made for depreciation in investments included in the AFS and HFT categories is ₹100.

(vii) The amounts debited to the P&L Account for provision should be debited under the head 'Expenditure - Provisions & Contingencies'. The amount transferred from the IRA to the P&L Account, should be shown as 'below the line' item in the Profit and Loss Appropriation Account, after determining the profit for the year. Provision towards any erosion in the value of an asset is an item of charge on the profit and loss account, and hence should appear in that account before arriving at the profit for the accounting period.

(viii) In terms of our guidelines on payment of dividend by banks, dividends should be payable only out of current year's profit. The amount drawn down from the IRA will, therefore, not be available to a bank for payment of dividend among the shareholders. However, the balance in the IRA transferred 'below the line' in the Profit and Loss Appropriation Account to Statutory Reserve, General Reserve or balance of Profit & Loss Account would be eligible to be reckoned as Tier I capital.

4.8 Disclosure Requirements on Advances Restructured by Banks and Financial Institutions

Reserve of India has framed Disclosure Requirements on Advances Restructured by Banks and Financial Institutions vide Circular DBOD.BP.BC.No.80/21.04.132/2012-13 dated January 31, 2013. These disclosure requirements will be effective from the financial year 2012-13.

Paragraph 16 of Master Circular on Prudential norms on Income Recognition, Asset Classification and Provisioning pertaining to Advances dated July 2, 2012 states manner in terms of which banks should disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances under the categories- Standard; Sub-Standard; and Doubtful Advances. Under each category, advances restructured under CDR Mechanism, SME Debt Restructuring Mechanism and other categories of restructuring are required to be shown separately.

The Working Group (WG) constituted by RBI to review the existing Prudential Guidelines on Restructuring of Advances had recommended that once the higher provisions and risk weights (if applicable) on restructured advances (classified as standard either abinitio or on upgradation from NPA category) revert back to the normal level on account of satisfactory performance during the prescribed period, such advances should no longer be required to be disclosed by banks as restructured accounts in the "Notes on Accounts" in their Annual Balance Sheets. However, the provision for diminution in the fair value of restructured accounts on such restructured accounts should continue to be maintained by banks as per the existing instructions. The WG also recommended that banks may be required to disclose: (i) Details of accounts restructured on a cumulative basis excluding the standard restructured accounts which cease to attract higher provision and risk weight (if applicable); (ii) Provisions made on restructured accounts under various categories; and (iii) Details of movement of restructured accounts.

This recommendation has been accepted in view of the fact that in terms of present guidelines, banks are required to disclose annually all accounts restructured in their books on a cumulative basis even though many of them would have subsequently shown satisfactory performance over a sufficiently long period. As such the present position of disclosures do not take into account the fact that in many of these accounts the inherent weaknesses have disappeared and the accounts are in fact standard in all respects, but continue to be disclosed as restructured advances. Accordingly, banks should henceforth disclose in their published Annual Balance Sheets, under "Notes on Accounts", information relating to number and amount of advances restructured, and the amount of diminution in the fair value of the restructured advances as per the prescribed format. Detailed instructions relating to the disclosure are also given in the format.

Unit – 5 : Some Special Transactions of Banks

Learning Objective

After studying this chapter, you will be able to understand

- Learn the concept of a rebate on bills discounted. Try to understand the technique of computing such rebate.
- Understand the technique for considering acceptance and endorsement as assets as well as liability.

5.1 Discounting, Collection & Acceptance of Bills

With reference to Bills, a banking company performs the following functions:

1. Discounting of bills
2. Collection of bills
3. Acceptances on behalf of customers

5.1.1 Discounting : A bank may straight away purchase a Bill (Discounting). In this case after reducing discount charges, the balance amount is credited to the account of the customer. The total of both is debited to 'Bills purchased and discounted account'. This account is an Asset. For example, a person holds a bill of exchange duly accepted by his customer for retirement after 90 days. He may either wait for 90 days or have the same bill discounted with his banker who will credit the amount under a bill after deducting the discounting charges, to his account with the bank. On due date the bank will retire the bill with the customer and get his payment.

Rebate on Bills Discounted

Banks discount hundreds of bills every day and when someone gets a bill discounted, the bank credits the discount account with the fall amount of the discount, the bank will earn in respect of that bill. But in practice, it frequently happens that some of these bills will not mature by the close of the accounting year. The portion of the discount which relates to the period falling after the close of the accounting period is called 'rebate on bills discounted', or 'unearned discount'.

Example

A customer discounted a four month's bill from bank on 1st March, 2013 and bank charged ₹ 800 as discount. Accounts are closed on 31st March every Year. The date or maturity of the bill is 31st June, 2013. In this transaction the bank must have credited the discount account with ₹ 800 on 1st March. But out of this, the discount for the months of April, May and June 2013 is not actually earned. Unearned discount for these three months @ ₹ 200 per month amounts to ₹ 600. This is the income which is related to the next accounting period and is called 'income received but not earned. It is also termed as 'rebate on hills discounted' or 'unexpired discount' or 'discount received in advance.'

Since discount on bill discounted is an income for the bank and is shown in the Profit & Loss Account under schedule 13, the amount of unexpired discount, if given in the adjustments, is deducted from schedule 13 and is also shown on the liabilities side of the balance sheet in the item 'other liabilities and provisions' in schedule 15. Following entry is made for the adjustment:

Discount A/c Dr.

To Rebate on Bills Discounted A/c

(For adjustment of unexpired discount)

Note: However, if the account of unexpired discount is given inside the trial balance, it is shown only in the balance sheet.

The Rebate A/c is shown on the liability side of the Balance Sheet as income received which has not accrued before the close of the year. Immediately on commencement of next financial year the Rebate A/c is closed by transfer to the credit of Discount A/c.

Illustration 1

The following is an extract from Trial Balance of overseas Bank as at 31st March, 2013

	₹	₹
Bills discounted	*12,64,000*	
Rebate on bills discounted not due on March 31st, 2012		*22,160*
Discount received		*1,05,708*

An analysis of the bills discounted is as follows:

	Amount ₹	*Due Date 2013*	*Rate of Discount* (%)
(i)	*1,40,000*	*June 5*	*14*
(ii)	*4,36,000*	*June 12*	*14*
(iii)	*2,82,000*	*June 25*	*14*
(iv)	*4,06,000*	*July 6*	*16*

Calculate Rebate on Bills Discounted as on 31-3-2013 and show necessary journal entries.

Solution

In order to determine the amount to be credited to the Profit and Loss A/c it is necessary to first ascertain the amount attributable to the unexpired portion of the period of the respective bills. The workings are as given below :

(i) The bill is due on 5th June; hence the number of days after March 31st, is 66. The discount on ₹ 1,40,000 for 66 days @ 14% per annum will be

14/100 × 66/365 × ₹ 1,40,000 = ₹ 3,544.

(ii) Number of days in the unexpired portion of the bill is 73: discount on ₹ 4,36,000 for 73 days @ 14% per annum will be ₹ 12,208.

(iii) Number of days in the unexpired portion of the period of the bill is 86: discount on

₹ 2,82,000 for 86 days @ 14% per annum will be ₹ 9,302.

(iv) Number of days in the unexpired portion of the period of the bill is 97: discount on ₹ 4,06,000 for 97 days @ 16 % p.a. will be ₹ 17,263.

The amount of discount to be credited to the Profit and Loss Account will be:

	₹
Transfer from Rebate on bills discount as on 31-3-2012	22,160
Add: Discount received during the year ended 31-3-2013	1,05,708
	1,27,868
Less: Rebate on bills discounted as on 31.3.2013(3,544 + 12,208 + 9,302+ 17,263)	(42,317)
	85,551

The journal entries will be as follows :

		Dr. ₹	*Cr.* ₹
Rebate on Bills Discounted A/c	Dr.	22,160	
To Discount on Bills A/c			22,160
(Being the transfer of Rebate on Bills Discounted on 31-3-2011 to Discount on Bills Account)			
Discount on Bills A/c	Dr.	42,317	
To Rebate on Bills Discounted A/c			42,317
(Being the transfer of rebate on bills discounted required on 31-3-2011 from discount on Bills Account)			
Discount on Bills A/c	Dr.	85,551	
To Profit and Loss A/c			85,551
(Being the amount of discount on Bills transferred to Profit and Loss Account)			

Note: In the Profit and Loss Account, the discount on bills will not appear as a separate item but will be included in the heading Interest/Discount on advances/bills as per Form B of the new format.

Illustration 2

On 31st March, 2012, Uncertain Bank had a balance of ₹ 9 crores in "rebate on bills discounted" account. During the year ended 31st March, 2013, Uncertain Bank discounted bills of exchange of ₹ 4,000 crores charging interest at 18% per annum the average period of discount being for 73 days. Of these, bills of exchange of ₹ 600 crores were due for realisation *from the acceptors/customers after 31st March, 2013, the average period outstanding after 31st March, 2013 being 36.5 days.*

Uncertain Bank asks you to pass journal entries and show the ledger accounts pertaining to:

(i) discounting of bills of exchange and

(ii) rebate on bills discounted.

Solution

Uncertain Bank
Journal Entries

(Rupees in crores)

		Dr. ₹	*Cr.* ₹
Rebate on bills discounted A/c	Dr.	9.00	
To Discount on bills A/c			9.00
(Being the transfer of opening balance in rebate on bills discounted account to discount on bills account)			
Bills purchased and discounted A/c	Dr.	4000.00	
To Discount on bills A/c			144.00
$\left[₹\ 4{,}000\,\text{crores} \times \frac{18}{100} \times \frac{73}{365}\right]$			
To Clients A/c			3,856.00
(Being the discounting of bills of exchange during the year)			
Discount on bills A/c	Dr.	10.80	
To Rebate on bills discounted A/c			10.80
(Being the unexpired portion of discount in respect of the discounted bills of exchange carried forward 18% of 600 crs for average period of 36.5 days)			
Discount on bills A/c	Dr.	142.20	
To Profit and loss A/c			142.20
(Being the amount of income for the year from discounting of bills of exchange transferred to Profit and Loss A/c)			

Ledger Accounts

(i) **Discount on bills Account**

2013		₹	*2012*		₹
March 31	To Rebate on bills discounted A/c	10.80	April 1	By Rebate on bills discounted A/c	9.00

	To Profit and loss A/c	142.20	2012-13	By Bills purchased and discounted A/c	144.00
		153.00			153.00

(ii) **Rebate on bills discounted Account**

2012		₹	2012		₹
April 1	To Discount on bills A/c	9.00	April 1	By Balance b/d	9.00
2013 March 31,	To Balance c/d	10.80	2013 March 31	By Discount on bills A/c	10.80
		19.80			19.80

Illustration 3

The following information is available in the books of X Bank Limited as on 31st March, 2013:

	₹
Bills discounted	*1,37,05,000*
Rebate on Bills discounted (as on 1.4.2012)	*2,21,600*
Discount received	*10,56,650*

Details of bills discounted are as follows:

Value of bill (₹)	Due date	*Rate of Discount*
18,25,000	5.6.2013	*12%*
50,00,000	12.6.2013	*12%*
28,20,000	25.6.2013	*14%*
40,60,000	6.7.2013	*16%*

Calculate the rebate on bills discounted as on 31.3.2013 and give necessary journal entries.

Solution

Statement showing rebate on bills discounted

Value	Due Date	Days after 31.3.2013	Rate of discount	Discount Amount
18,25,000	5.6.2013	(30+ 31+5) = 66	12%	39,600
50,00,000	12.6.2013	(30+31+12) = 73	12%	1,20,000
28,20,000	25.6.2013	(30+31+25) = 86	14%	93,021
40,60,000	6.7.2013	(30+ 31+ 30+ 6) = 97	16%	1,72,633
1,37,05,000	Rebate on bills discounted on 31.3.2013			4,25,254

In the books of X Bank Ltd.
Journal Entries

(i)	Rebate on bills discounted Account	Dr.	2,21,600	
	To Discount on bills Account			2,21,600
	[Being opening balance of rebate on bills discounted account transferred to discount on bills account]			
(ii)	Discount on bills Account	Dr.	4,25,254	
	To Rebate on bills discounted Account			4,25,254
	[Being provision made on 31st March, 2013]			
(iii)	Discount on bills Account	Dr.	8,52,996	
	To Profit and loss Account			8,52,996
	[Being transfer of discount on bills, of the year, to profit and loss account)			

Credit to Profit and Loss A/c will be as follows: ₹ (10,56,650 + 2,21,600 – 4,25,254) = ₹ 8,52,996

Illustration 4

Calculate Rebate on Bills discounted as on 31 December, 2013 from the following data and show journal entries:

	Date of Bill	*₹*	*Period*	*Rate of Discount*
(i)	*15.10.13*	*25,000*	*5 months*	*8%*
(ii)	*10.11.13*	*15,000*	*4 months*	*7%*
(iii)	*25.11.13*	*20,000*	*4 months*	*7%*
(iv)	*20.12.13*	*30,000*	*3 months*	*9%*

Solution

(a) Calculation of Rebate on Bills Discounted

₹	Due Date	Days after 31 December 2013	Discount Rate	₹
25,000	18-03-2014	31 + 28 + 18 = 77	8%	421.92
15,000	13-03-2014	3 1 + 28 + 13 = 72	7%	207.12
20,000	28-03-2014	3 1 + 28 + 28 = 87	7%	333.69
30,000	23-03-2014	3 1 + 28 + 23 = 82	9%	606.57
		Total		1569.30

Journal Entry

Date	Particulars	Debit ₹	Credit ₹
Dec. 31	Interest and Discount Account Dr. To Rebate on Bills Discounted (Being the provision for unexpired discount required at the end of the year)	1569.30	1569.30

5.1.2 Collection of Bills: One of the services provided by banks to their customers is to collect the dues against Bills of Exchange from their customers on the due dates. Where the bills have been discounted the proceeds of such bills on due date are treated as incomes of the bank. On the other hand, if bills have not been discounted, the proceeds on the same on maturity are credited to the account of the customer. The particulars will be recorded in a separate book called Bills for Collection Register. Bills sent for collection have to be shown by way of Note as per Third Schedule.

Two Accounts have to be opened. They are mirror images of each other. They are:

(i) Bills for Collection (Asset)

(ii) Bills for Collection (Liability)

Illustration 5

On 01.04.2013 bills for collection was 7 lacs. During 2013-14 bills received for collection amounted to 64.5 lacs. Bills collected were 47 lacs. Bills dishonoured was 5.5 lacs. Prepare Bills for collection (Assets) and Bills for Collection (Liabilities) Accounts.

Solution

Bills for Collection (Assets) Account

	₹ in lacs		₹ in lacs
To Balance b/d	7	By Bills for collection	47
To Bills for collection	64.5	By Bills dishonoured	5.5
		By Balance c/d	19
	71.5		71.5

Bills for Collection (Liabilities) Account

	₹ in lacs		₹ in lacs
To Bills for collection	47	By Balance b/d	7
TBills dishonoured	5.5	By Bills for collection	64.5
By Balance c/d	19		
	71.5		71.5

5.1.3 Acceptance and Endorsement: A bank has more acceptable credit as compared to that of its customer, because of this more often than not the bank is called to accept or endorse a bill on behalf of its customers. The bank has to honour this acceptance on behalf of its client only in the event of a client failing to honour the bill on the due date.

As against this liability, the bank has a corresponding claim against the customer on whose behalf it has undertaken to be a party to the bill, either as an acceptor or as an endorser.

Such Acceptance (Liabilities) which are outstanding at the close of the year and the corresponding asset (security) is disclosed as Contingent liability. As a safeguard against the customer not being able to meet the demand of the bank in this respect, usually the bank requires the customer to deposit a security equivalent to the amount of the bill accepted on his behalf.

If the bill, at the end of its term, has to be retired by the bank and the amount cannot be collected from the customer on demand, the bank reimburses itself by disposing of the security deposited by the customer.

5.1.3.1 Drafts and telegraphic Remittances: When a bank issues a bank draft on another bank or on its branch, it credits the account of the bank or that of the branch with amount of the draft. The corresponding debit is raised in the account of the customer. His account is also debited with the remittances. A similar procedure is adopted in case of telegraphic transfer made on account of customers.

5.1.3.2 Letters of Credit and Travellers' Cheques: These are issued as a facility to travellers within the country or abroad. In either case, the person desiring such instruments of credit, to be issued in his favour or some other party is made to deposit the full value of the letter of credit or travellers' cheques issued in his favour.

The amount deposited by the customer is placed to the credit of Letters of Credit Account or Travellers' Cheques Account, as the case may be. When the bills of Exchanges drawn against the Letters of credit are received for payment, the amount is debited to the Letter of Credit Account. Similarly, the travellers' cheques, when presented are debited to the Travellers' Cheque Account. In the case of customers desiring travellers' cheques in a foreign currency, the equivalent value thereof in home currency in collected from them at the rate of exchange prevailing on the date of issue of the traveller's cheque and the bank either purchases immediately the amount of foreign exchange equal to the value of the travellers' cheque issued, or transfers out of its balances of foreign currency an amount equivalent to the value of travellers' cheques to the Travellers' Cheques Account. In the case of letters of credit in foreign currency, the same procedure is followed.

The transactions entered into for rendering other services *e.g.*, collection of dividend and interest, making periodical payments etc. do not involve any complicated accounting. Basically, when any amount is collected for a customer as dividend or interest, his account is credited and cash is debited. Correspondingly, wherever any payment is made on account of a customer, his account is debited and cash is credited. Usually a separate charge is made for such a service.

Illustration 6

From the following details prepare "Acceptances, Endorsements and other Obligation A/c" as would appear in the General Ledger.

On 1.4.2013 Acceptances not yet satisfied stood at ₹ 22,30,000. Out of which ₹ 20 lacs were subsequently paid off by clients and bank had to honour the rest. A scrutiny of the Acceptance Register (for transactions during the year) revealed the following :

ClientAcceptances/GuaranteesRemarks

	₹	
A	*10,00,000*	*Bank honoured on 10.6.2013*
B	*12,00,000*	*Party paid off on 30.9. 2013*
C	*5,00,000*	*Party failed to pay and bank had to honour on 30.11.2013*
D	*8,00,000*	*Not satisfied upto 31.3.2014*
E	*5,00,000*	*-do-*
F	*2,70,000*	*-do-*
Total	*42,70,000*	

Solution

Acceptances, Endorsements and other Obligation Account (in general ledger)

		₹ '000			₹ '000
2013-14	To Constituents' liabilities for acceptances/guarantees etc.		1.4.13	By Balance b/d	22,30
	(Paid off by clients)	20,00	2013-14	By Constituents' liabilities for	
	To Constituent's liabilities for			A 10,00	
	acceptances/guarantees etc.	2,30		B 12,00	
	(Honoured by bank			C 5,00	
	₹ 22.30 lakhs less			D 8,00	
	₹ 20 lakhs)			E 5,00	
10.6.2013	To Constituents' liabilities for acceptances/guarantees etc.			F 2,70	42,70
	(Honoured by bank)	10,00			
30.9.2013	To Constituents' liabilities for acceptances/guarantees etc.				
	(Paid off by party)	12,00			
30.11.2013	To Constituent's liabilities for				

31.3.2014	acceptances/guarantees etc. (Honoured by bank on party's failure to pay) To Balance c/d (Acceptances not yet satisfied)	5,00 15,70			
		65,00			65,00

Illustration 7

Following facts have been taken out from the records of Adarsha Bank in respect of the year ending March 31, 2013:

(a) On 1-4-2012 Bills for collection were ₹ 7,00,000. During 2012-2013 bills received for collection amounted to ₹ 64,50,000, bills collected were ₹ 47,00,000 and bills dishonoured and returned were ₹ 5,50,500. Prepare Bills for Collection (Assets) A/c and bills for Collection (Liability) A/c.

(b) On 1-4-2012, Acceptance, Endorsement, etc. not yet satisfied amounted to ₹ 14,50,000. During the year under question, Acceptances, Endorsements, Guarantees etc., amounted to ₹ 44,00,000. Bank honoured acceptances to the extent of ₹ 25,00,000 and client paid off ₹ 10,00,000 against the guaranteed liability. Clients failed to pay ₹ 1,00,000 which the Bank had to pay. Prepare the "Acceptances, Endorsements and other Obligations A/c" as it would appear in the General ledger.

(c) It is found from the books, that a loan of ₹ 6,00,000 was advanced on 30-9-2012 @ 10 per cent p.a. interest payable half yearly; but the loan was outstanding as on 31-3-2013 without any payment recorded in the meantime, either towards principal or towards interest. The security for the loan was 10,000 fully paid shares of ₹ 100 each (the market value was ₹ 98 as per the Stock Exchange information as on 30th Sept., 2012). But due to fluctuations, the price fell to ₹ 40 per share in January, 2013. On 31-3-2013, the price as per Stock Exchange rate was ₹ 82 per share. State how you would classify the loan as secured/unsecured in the Balance Sheet of the Company.

(d) The following balances are extracted from the Trial Balance as on 31-3-2013:

	Dr. ₹	*Cr.* ₹
Interest and Discounts		*98,00,000*
Rebate for bills discounted		*20,000*
Bills discounted and purchased	*4,00,000*	

It is ascertained that the proportionate discounts not yet earned for bills to mature in 2012-2013 amount to ₹ 14,000. Prepare Ledger Accounts.

Solution

(a) Bills for Collection (Assets) A/c

2012		₹	*2012-13*		₹
Apr. 1	To Balance b/d	7,00,000		By Bills for Collection (Liabilities) A/c	47,00,000
2012-13	To Bills for Collection (liabilities) A/c	64,50,000		By Bills for collection (Liabilities) A/c	5,50,500
			2013 Mar. 31	By Balance c/d	18,99,500
		71,50,000			71,50,000

Bills for Collection (Liabilities) Account

2012-13		₹	*2012*	₹	
	To Bills for collection (Assets) A/c	47,00,000	Apr. 1	By Balance b/d	7,00,000
	To Bills for Collection (Assets) A/c	5,50,500	2012-13	By Bills for collection (Assets) A/c	64,50,000
2013 Mar. 31	To Balance c/d	18,99,500			
		71,50,000			71,50,000

(b) Acceptances, Endorsement & other Obligation Account

2012-13		₹	*2012*		₹
	To Constituents' Liability for Acceptance, Endorsement, etc.	25,00,000	Apr. 1	By Balance b/d	14,50,000
	To Constituents' Liability for Acceptances, Endorsement etc.	10,00,000	2012-13	By Constituents, Liabilities for Acceptances, Endorsements, etc.	44,00,000
	To Constituents' Liability for Acceptances, Endorsements, etc. (amount paid on failure of clients)	1,00,000			
Mar. 31	To Balance c/d	22,50,000			
		58,50,000			58,50,000

(c) For classifying loans as fully secured or otherwise, the value of the security as on the last date of the year is considered. The value of the security is ₹ 8,20,000 covering the loan and the interest due comfortably. Hence it is to be treated as good and fully secured.

(d) **Rebate on Bills Discounted Account**

		₹			₹
2012-13	To Interest and Discount A/c	6,000	2012 Apr. 1	By Balance b/d	20,000
2013 Mar. 31	To Balance c/d	14,000			
		20,000			20,000

Interest & Discount Account

2013		₹	*2012*		₹
Mar. 31	To Profit & Loss A/c	98,06,000	Apr. 1	By Balance b/d	98,00,000
			2012-13	By Rebate on Bills discounted A/c	6,000
		98,06,000			98,06,000

Unit – 6 : Preparation of Financial Statements of Banks

Learning Objectives

After studying this unit, you will be able to:

- Learn how to prepare profit and loss account of a bank.
- Compute tax provision, transfer to statutory reserve, provisions on non-performing assets, income recognition on NPA, depreciation on current investments.
- Learn how to prepare Balance-sheet.

6.1 Introduction

Forms for the preparation and presentation of financial statements of banking companies have been given in Annexure I & II along with compliance guidelines of RBI given in Annexure III after the chapter. In this unit we shall straightaway go to the problems relating to preparation of final accounts of banks.

Illustration 1

From the following information, prepare a Balance Sheet of ADT International Bank as on 31st March, 2013 giving the relevant schedules and also specify at least four important Principal Accounting Polices :

₹ in lakhs

	Dr.	Cr.
Share Capital		198.00
19,80,000 Shares of ₹ 10 each		
Statutory Reserve		231.00
Net Profit before Appropriation		150.00
Profit and Loss Account		412.00
Fixed Deposit Account		517.00
Savings Deposit Account		450.00
Current Accounts	28.00	520.12
Bills Payable		0.10
Cash credits	812.10	
Borrowings from other Banks		110.00
Cash in Hand	160.15	
Cash with RBI	37.88	
Cash with other Banks	155.87	
Money at Call	210.12	
Gold	55.23	

Government Securities	110.17	
Premises	155.70	
Furniture	70.12	
Term Loan	792.88	
	2,588.22	2,588.22

Additional Information:

Bills for collection	18,10,000
Acceptances and endorsements	14,12,000
Claims against the Bank not acknowledged as debt	55,000
Depreciation charges—Premises	1,10,000
Furniture	78,000

50% of the Term Loans are secured by Government guarantees. 10% of cash credit is unsecured.

Solution

Balance Sheet of ADT International Bank
As on 31st March, 2013

(₹ in lacs)

Capital and Liabilities	**Schedule**	**As on 31.3.13**	**As on 31.3.12**
Share Capital	1	1,98.00	
Reserves and Surplus	2	7,93.00	
Deposits	3	14,87.12	
Borrowings	4	1,10.00	
Other liabilities and provisions	5	0.10	
		25,88.22	
Assets			
Cash and balances with RBI	6	219.63	
Balances with banks and money at call and short notice	7	344.39	
Investments	8	1,65.40	
Advances	9	16,32.98	
Fixed Assets	10	2,25.82	
Other Assets	11	–	
		25,88.22	
Contingent liabilities	12	14.67	
Bills for collection		18.10	

Schedule 1— Capital

Authorised Capital	–
Issued, Subscribed and	
Paid up Capital	
19,80,000 Shares of ₹ 10 each	1,98.00

Schedule 2— Reserves and Surplus

(1)	Statutory Reserve-		
	Opening balance	2,31.00	
	Additions during the year	37.50	
			268.50
(2)	Balance in Profit & Loss		
	Account *(W.N. 1)*		524.50
			7,93.00

Schedule 3— Deposits

(i)	Demand deposits from others	5,20.12
(ii)	Saving bank deposits	4,50.00
(iii)	Fixed Deposits	5,17.00
		14,87.12

Schedule 4— Borrowings

Borrowing in India-	
Other banks	1,10.00

Schedule 5— Other Liabilities and Provisions

Bills Payable	0.10

Schedule 6— Cash and balances with RBI

(i)	Cash in hand	1,60.15
(ii)	Balances with RBI	
	In current account *(W.N. 2)*	59.48
		219.63

Schedule 7—Balances with banks and money at call and short notice

1.	In India	
	(i) Balances with banks	
	(a) in current accounts *(W.N. 3)*	1,34.27
	(ii) Money at call and short notice	2,10.12
		344.39

Schedule 8— Investments

(1)	Investment in India in	
	(i) Government securities	1,10.17
	(ii) Others—Gold	55.23
		1,65.40

Schedule 9— Advances

A.	(i)	Cash credits, overdrafts (includes Dr Bal in Current A/c as ODs)	8,40.10
	(ii)	Term Loans	7,92.88
			16,32.98
B	(i)	Secured by tangible assets (balancing fig)	11,52.53
	(ii)	Secured by bank/government guarantees	3,96.44
	(iii)	Unsecured	84.01
			16,32.98

Schedule 10— Fixed Assets

1.	Premises	
	At cost on 31st March, 2012	156.80
	Depreciation to date	1.10
		155.70
2.	Other Fixed Assets	
	Furniture at cost on 31st March, 2012	70.90
	Depreciation to date	0.78
		70.12
	Total (1 + 2)	2,25.82

Schedule 11— Other Assets

Nil

Schedule 12— Contingent Liabilities

(₹ *in lakhs)*

(i)	Claims against bank not acknowledged as debts	0.55
(ii)	Acceptances, endorsements	14.12
		14.67

Working Note :

(1) Balance in Profit & Loss Account : (₹ in lakhs)

Net Profit before appropriation	1,50.00
Add : Profit for the year	4,12.00
	5,62.00
Less : Transfer to statutory reserve (25% of 150.00)	(37.50)
	524.50

(2) Transfer from Cash with other banks to Cash with RBI (when CRR is required to be maintained at 4% of deposits w.e.f. January 29, 2013)

Cash reserve required (14,87.12 x 4%)	59.48
Cash with RBI	(37.88)
Transfer needed to maintain cash reserve	21.60

(3) Liquid Assets :

Cash on hand	1,60.15
Cash with other Banks	1,55.87
Money at call and short notice	2,10.12
Gold	55.23
Government securities	1,10.17
	6,91.54
Excess liquidity [6,91.54 – (1487.12 x 23%)] or (6,91.54 – 342.04)	349.50

The excess liquidity enables the transfer as per (2) above.

After the transfer, Cash with other Banks = ₹ (in lakhs) (1,55.87 - 21.60) = ₹ (in lakhs) 134.27.

Principal Accounting Policies:

(a) Foreign Exchange Transactions

(i) Monetary assets and liabilities have been translated at the exchange rate prevailing at the close of year. Non-monetary assets have been carried in the books at the historical cost.

(ii) Income and Expenditure items in respect of Indian branches have been translated at the exchange rates on the date of transactions and in respect of foreign branches at the exchange rates prevailing at the close of the year.

(iii) Profit or Loss on foreign currency position including pending forward exchange contracts have been accounted for at the exchange rates prevailing at the close of the year.

(b) Investment: Permanent category investments are valued at cost. Valuation of investment in current category depends on the nature of securities. While valuation of government securities held as current investments have been made on yield to maturity basis, the investments in shares of companies are valued on the basis of book value.

(c) Advances: Advances due from sick nationalised units under nursing programmes and in respect of various sticky, suit filed and decreed accounts have been considered good on the basis of–

(i) Available estimate value of existing and prospective primary and collateral securities including personal worth of the borrowers and guarantors.

(ii) The claim lodged/to be lodged under various credit guarantee schemes.

(iii) The claim lodged/to be lodged under various credit guarantee schemes.

(iv) Pending settlement of claims by Govt.

Provisions to the satisfaction of auditors have been made and deducted from advances. Tax relief available when the advance is written off will be accounted for in the year of write-off.

(d) Fixed Assets: The premises and other fixed assets except for foreign branches are accounted for at their historical cost. Depreciation has been provided on written down value method at the rates specified in the Income Tax Rules, 1962. Depreciation in respect of assets of foreign branches has been provided as per the local laws.

Illustration 2

From the following information, prepare Profit and Loss A/c of Dimple Bank as on 31-3-2013 :

₹ '000	*Item*	*₹ '000*
2011-12		*2012-13*
14,27	*Interest and Discount*	*20,45*
1,14	*Income from investment*	*1,12*

1,55	*Interest on Balances with RBI*	*1,77*
7,22	*Commission, Exchange and Brokerage*	*7,12*
12	*Profit on sale of investments*	*1,22*
6,12	*Interest on Deposits*	*8,22*
1,27	*Interest to RBI*	*1,47*
7,27	*Payment to and provision for employees*	*8,55*
1,58	*Rent, taxes and lighting*	*1,79*
1,47	*Printing and stationery*	*2,12*
1,12	*Advertisement and publicity*	*98*
98	*Depreciation*	*98*
1,48	*Director's fees*	*2,12*
1,10	*Auditor's fees*	*1,10*
50	*Law charges*	*1,52*
48	*Postage, telegrams and telephones*	*62*
42	*Insurance*	*52*
57	*Repair & maintenance*	*66*

Also give necessary Schedules.

Other Information:

(i) The following items are already adjusted with Interest and Discount (Cr.):

Tax Provision ('000 ₹)	*1,48*
Provision for Doubtful Debts ('000 ₹)	*92*
Loss on sale of investments ('000 ₹)	*12*
Rebate on Bills discounted ('000 ₹)	*55*

(ii) Appropriations :

25% of profit is transferred to Statutory Reserves

5% of profit is transferred to Revenue Reserve.

Solution

Dimple Bank
Profit and Loss Account for the year ended 31-3-2013

		Schedule No.	*Year ended 31-3-2013*	*(₹ 000's)* *Year ended 31-3-2012*
I.	**Income**			
	Interest Earned	13	25,86	16,96

	Other Income	14	8,22	7,34
	Total		34,08	24,30
II.	**Expenditure**			
	Interest Expended	15	9,69	7,39
	Operating Expenses	16	20,96	16,97
	Provisions and Contingencies		2,40	
	Total		33,05	24,36
III.	**Profit/Loss**			
	Net Profit/Loss (—) for the year		1,03	(6)
	Profit/Loss (—) brought forward		(6)	
	Total		97	(6)
IV.	**Appropriations**			
	Transfer to Statutory Reserve		25.75	
	Transfer to Other Reserve, Proposed Dividend		5.15	
	Balance carried over to Balance Sheet		66.10	
	Total		97.00	

Schedule 13 - Interest Earned

(₹ 000's)

		Year ended 31-3-2013	*Year ended 31-3-2012*
I.	Interest/Discount	22,97	14,27
II.	Income on Investments	1,12	1,14
III.	Interest on Balances with RBI and other inter-bank fund	1,77	1,55
IV.	Others		–
	Total	25,86	16,96

Schedule 14 - Other Income

(₹ 000's)

			Year ended 31-3-2013	*Year ended 31-3-2012*
I.	Commission, Exchange and Brokerage		7,12	7,22
II.	Profit on Sale of Investments	1,22		12

Less: Loss on sale of Investments	(12)	1,10	
Total		8,22	7,34

Schedule 15 - Interest Expended

			(₹ 000's)
		Year ended 31-3-2013	*Year ended 31-3-2012*
I.	Interest on Deposits	8,22	6,12
II.	Interest on RBI/inter-bank borrowings	1,47	1,27
	Total	9,69	7,39

Schedule 16 - Operating Expenses

			(₹ 000's)
		Year ended 31-3-2013	*Year ended 31-3-2012*
I.	Payments to and provision for employees	8,55	7,27
II.	Rent, taxes and lighting	1,79	1,58
III.	Printing and stationery	2,12	1,47
IV.	Advertisement and Publicity	98	1,12
V.	Depreciation on the Bank's Property	98	98
VI.	Director's fees, allowances and expenses	2,12	1,48
VII.	Auditor's fees and expenses		
	(including branch auditors)	1,10	1,10
VIII.	Law charges	1,52	50
IX.	Postage, telegrams, telephones etc.	62	48
X.	Repairs and maintenance	66	57
XI.	Insurance	52	42
XII.	Other Expenditure		–
	Total	20,96	16,97

Illustration 3

From the following information, prepare Profit and Loss A/c of KC Bank for the year ended 31st March, 2013:

Items	*₹ 000*
Interest on cash credit	*18,20*
Interest on overdraft	*7,50*
Interest on term loans	*15,40*
Income on investments	*8,40*
Interest on balance with RBI	*1,50*
Commission on remittances and transfer	*75*
Commission on letters of credit	*1,18*
Commission on government business	*82*
Profit on sale of land and building	*27*
Loss on exchange transactions	*52*
Interest paid on deposit	*27,20*
Auditors' fees and allowances	*1,20*
Directors' fees and allowances	*2,50*
Advertisements	*1,80*
Salaries, allowances and bonus to employees	*12,40*
Payment to Provident Fund	*2,80*
Printing and stationery	*1,40*
Repairs and maintenance	*50*
Postage, telegrams, telephones	*80*

Other Information:

(i) *Interest on NPA is as follows*

	Earned (₹ '000)	*Collected (₹ '000)*
Cash credit	*8,20*	*40,00*
Overdraft	*450*	*1,00*
Term Loans	*750*	*2,50*

(ii) *Classification of Non Performing Advances ('000 ₹)*

	Standard	*30,00*
	Sub-standard	*11,20*
	Doubtful assets not covered by security	*2,00*
	Doubtful assets covered by security for one year	*50*
	Loss Assets	*2,00*
(iii)	*Investments*	*27,50*

Bank should not keep more than 25% of its investment as 'held-for-maturity' investment. The market value of its rest 75% investment is ₹ 19,75,000 as on 31-3-2013.

Solution

KC Bank
Profit and Loss Account
For the year ended 31st March, 2013

	Particulars	Schedule	(₹ '000') Year ended 31-3-2013
I	**Income**		
	Interest earned	13	38,30
	Other income	14	2,50
			40,80
II	**Expenditure**		
	Interest expended	15	27,20
	Operating expenses	16	23,40
	Provisions and Contingencies		680.00
			57,40
III	**Profit/Loss**		(16,60)
IV	**Appropriations**		Nil

Schedule 13 - Interest Earned

			Year ended 31-3-2013 (₹ '000')
I	Interest/discount on advances/bills		
	Interest on cash credit ₹ (18,20-420)	14,00	
	Interest on overdraft ₹ (750-350)	4,00	
	Interest on term loans ₹ (15,40-500)	10,40	28,40
II	Income on investments		8,40
III	Interest on Balance with RBI		1,50
			38,30

Interest on NPA is recognised on cash basis, hence excess reduced

Schedule 14 - Other Income

			Year ended 31-3-2013 (₹ '000')
I	Commission, Exchange and Brokerage		
	Commission on remittances and transfer	75	
	Commission on letter of credit	1,18	
	Commission on Government business	82	2,75

II	Profit on sale of Land and Building			27
III	Loss on Exchange Transactions			(52)
				2,50

Schedule 15 - Interest Expended

		Year ended 31-3-2013
I	Interest on Deposits	27,20

Schedule 16 - Operating Expenses

			Year Ended 31-3-2013
I	Payment and provision for employees		
	Salaries, allowances and bonus	12,40	
	Provident Fund Contribution	2,80	15,20
II	Printing and Stationery		1,40
III	Advertisement and publicity		1,80
IV	Directors' fees, allowances and expenses		2,50
V	Auditors' fees and expenses		1,20
VI	Postage, telegrams, telephones etc.		80
VII	Repairs and maintenance		50
			23,40

Working Note:

Provisions and contingencies			*(₹'000)*
Provision for NPA :			
Standard	3,000 × 0.40%		12
Sub-standard	1,120 × 15%*		1,68
Doubtful not covered by security	200 × 100%		2,00
Doubtful covered by security for one year	50 × 25%		12.5
Loss Assets	(200 × 100%)		2,00
			592.5
Depreciation on current investments			
Cost (75% of 27,50)		2,062.50	
Less : Market value		(1,975.00)	87.5
			680.00

Note: 25% of the total investments are held to maturity. In the case of Held to Maturity investments the valuation is done at cost and these are not marked to market value generally.

* It is assumed that sub-standard asset is fully secured.

Hence, depreciation on investments has been calculated only on other investments which can either be Held for Trading (HFT) or Available for Sale (AFS)

Illustration 4

The following are the ledger balances (in Rupees thousands) extracted from the books of Vaishnavi Bank as on March 31, 2013 :

	Dr.	Cr.
Share Capital		19,00,00
Current accounts control		9,70,00
Employee security deposits		74,20
Investments in Govt. of India Bonds	9,43,70	
Gold Bullion	1,51,30	
Silver	20,00	
Constituent liabilities for acceptances and endorsements	5,65,00	5,65,00
Borrowings from banks		7,72,30
Building	6,50,00	
Furniture	50,00	
Money at call and short notice	2,60,00	
Commission & brokerage		2,53,00
Saving accounts		1,50,00
Fixed deposits		2,30,50
Balances with other banks	4,63,50	
Other investments	5,56,30	
Interest accrued on investments	2,46,20	
Reserve Fund		14,00,00
P & L A/c		65,00
Bills for collection	4,35,00	4,35,00
Interest		6,20,00
Loans	18,10,00	
Bills discounted	1,25,00	
Interest	79,50	
Discounts		4,20,00
Rents		6,00
Audit fees	50,00	
Depreciation reserve (furniture)		2,00
Salaries	2,12,00	
Rent, rates and taxes	1,20,00	

Cash in hand and with Reserve Bank	*7,50,00*	
Miscellaneous income		*39,00*
Depreciation reserve (building)		*8,00*
Directors fees	*10,00*	
Postage	*12,50*	
Loss on sale of investments	*2,00,00*	
Branch adjustments	*2,00,00*	
	79,10,00	*79,10,00*

Other Information:

The bank's Profit and Loss Account for the year ended and Balance Sheet as on 31st March, 2013 are required to be prepared in appropriate form. Further information (in Rupees thousands) available is as follows —

(a) Rebate on bills discounted to be provided 40,00

(b) Depreciation for the year

Building 50,00

Furniture 5,00

(c) Included in the current accounts ledger are accounts overdrawn to the extent of 25,00.

Solution

Balance Sheet of Vaishnavi Bank
as on 31st March, 2013

(₹ '000)

Capital and Liabilities	*Schedule*	*As on 31-3-2013*	*As on 31-3-2012*
Capital	1	19,00,00	
Reserves & Surplus	2	20,24,00	
Deposits	3	13,75,50	
Borrowings	4	7,72,30	
Other liabilities and provisions	5	1,14,20	
Total		61,86,00	

(₹ '000)

Assets	*Schedule*	*As on 31-3-2013*	*As on 31-3-2012*
Cash and balance with Reserve Bank of India	6	7,50,00	

Balances with bank and Money at call and short notice	7	7,23,50	
Investments	8	16,71,30	
Advances	9	19,60,00	
Fixed Assets	10	6,35,00	
Other Assets	11	4,46,20	
Total		61,86,00	
Contingent liabilities	12	5,65,00	
Bills for collection		4,35,00	

Vaishnavi Bank

Profit and Loss Account for the year ended 31-3-2013

(₹ '000)

I.	**Income**		
	Interest & Discount	13	10,00,00
	Other income	14	98,00
			10,98,00
II.	**Expenditure**		
	Interest Expended	15	79,50
	Operating Expenses	16	4,59,50
	Provisions and Contingencies		-
			5,39,00
III.	**Profits/Loss**		
	Net profit for the year		5,59,00
	Profit b/f		65,00
			6,24,00
IV.	**Appropriations**		
	Transfer to Statutory Reserve		1,39,75
	Balance carried over to Balance Sheet		4,84,25
			6,24,00

Schedule 1 - Capital

(₹ '000)

		As on 31-3-2013
I.	For Other Banks	
	Authorised Capital	
	Shares of ₹ ... each	–
	Issued Capital	

Shares of ₹ ... each	–
Subscribed Capital	
Shares of ₹ ... each	–
Called up capital	
Shares of ₹ ... each	19,00,00
	19,00,00

Schedule 2 - Reserves & Surplus

		As on 31-3-2013
I.	Statutory Reserves	
	Opening Balance	14,00,00
	Additions during the year	1,39,75
		15,39,75
II.	Balance in Profit and Loss Account	4,84,25
	Total	20,24,00

Note: Transfer to Statutory Reserve should be 25% of the Net Profits for the current year

Schedule 3 - Deposits

(*₹ '000*)

		As on 31-3-2013
A. I.	Demand Deposits	9,95,00
II.	Saving Bank Deposits	1,50,00
III.	Term Deposits	2,30,50
		13,75,50

Schedule 4 - Borrowings

		As on 31-3-2013
I.	Borrowings in India	
	(ii) Other banks	7,72,30
	Total	7,72,30

Schedule 5 - Other liabilities and provisions

		As on 31-3-2013
I.	Other liabilities including provisions:	
	Rebate on bills discounted	40,00
	Employees Security Deposit	74,20
	Total	1,14,20

Schedule 6 - Cash and Balances with Reserve Bank of India

			As on 31-3-2013
I.	Cash in hand (including foreign currency notes)		3,50,00
II.	Balances with Reserve Bank of India:		
	(i)	In Current Account	3,20,00
	(ii)	In Other Account	80,00
	Total		7,50,00

(Details are not based on figures given in the question)

Schedule 7 - Balances with Banks & Money at Calls & Short Notice

		As on 31-3-2013
I. (i)	In India Balances with banks	
(*a*)	in Current accounts	
(*b*)	in Other accounts	2,63,50
(ii)	Money at call and short notice	2,00,00
(*a*)	with banks	
(*b*)	with other institutions	2,30,00
	Total (i + ii)	30,00
		7,23,50

Schedule 8 - Investments

(₹ '000)

		As on 31-3-2013
I.	Investments in India in	
	(i) Government securities	9,43,70
	(ii) Shares (assumed)	5,56,30
	(iii) Gold	1,51,30
	(iv) Silver	20,00
	Total	16,71,30

Schedule 9 - Advances

			As on 31-3-2013
A.	(i)	Bills purchased and discounted	1,25,00
	(ii)	Cash credits, overdrafts and loans repayable on demand	18,35,00
			19,60,00

B.	(i)	Secured by tangible assets	12,00,00
	(ii)	Secured by Bank/Govt. Securities	2,00,00
	(iii)	Unsecured	5,60,00
			19,60,00
C.	I.	Advances in India	
	(i)	Priority sector	8,00,00
	(ii)	Public sector	1,00,00
	(iii)	Banks	20,00
	(iv)	Others	10,40,00
		Total	19,60,00

(Details are assumed)

Current Accounts Control A/c shows a Credit Balance of ₹ 9,70,000/-. In the additional information it is mentioned that in the above balance an OD of ₹ 25,000/- is included. Hence for presentation of the Balance Sheet the entries will be as under:

Current Accounts 9,95,000 to be shown under deposits

ODs in Current Accounts To be shown as Advances along with cash credits & T Loans

Schedule 10 - Fixed Assets

			As on 31-3-2013
I.	Premises		
	At cost as on 31st March, 2012	6,42,00	
	Depreciation to date	(50,00)	5,92,00
II.	Other fixed articles (including Furniture and Fixture)		
	At cost as on 31st March, 2012	48,00	
	Depreciation to date	(5,00)	43,00
	Total (I & II)		6,35,00

Schedule 11 - Other Assets

		As on 31-3-2013
I.	Inter-office adjustments (net)	2,00,00
II.	Interest accrued	2,46,20
		4,46,20

Schedule 12 - Contingent Liabilities

		Year ended 31-3-2013
I.	Acceptances, endorsements and other obligations	5,65,00
	Total	5,65,00

Schedule 13 : Interest Earned

	Year ended 31-3-2013
I. Interest/discount on advances, bills (6,20,00 + 4,20,00 –40,00)	10,00,00
Total	10,00,00

Schedule 14 : Other Income

			Year ended 31-3-2013
I.	Commission, Exchange and Brokerage	2,53,00	
II.	Profit on sale of investments		
	Less : Loss on sale on investments	(2,00,00)	53,00
III.	Miscellaneous Income		
	Rent and Other Receipts		45,00
	Total		98,00

Schedule 15 : Interest Expended

		Year ended 31-3-2013
I.	Interest on Deposits	79,50
	Total	79,50

Schedule 16 : Operating Expenses

		Year ended 31-3-2013
I.	Payments to and provisions for employees	2,12,00
II.	Rent, Taxes and Lighting	1,20,00
III.	Depreciation on Bank's property	55,00

IV.	Director's fees, allowances and expenses	10,00
V.	Auditor's fees and expenses	50,00
VI.	Postage, Telegrams, Telephones etc.	12,50
	Total	4,59,50

Annexure I

Schedules forming part of Balance Sheet

Schedule 1 - Capital

	As on 31.3... (Current year)	As on 31.3... (Previous year)
I. For Nationalised Banks		
Capital (Fully owned by Central Government)		
II. For Banks Incorporated outside India		
Capital		
(i) (The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head)		
(ii) Amount of deposit kept with the RBI under Section 11(2) of the Banking Regulation Act, 1949		
Total		
III. For other Banks		
Authorised Capital (___Shares of ₹ ____ each)		
Issued Capital (___Shares of ₹ ____each)		
Subscribed Capital (____Shares of ₹ ___ each)		
Called-up Capital (____Shares of ₹ ___ each)		
Less : Calls unpaid		
Add : Forfeited shares		
Total		

Schedule 2 - Reserves and Surplus

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Statutory Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
II.	**Capital Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
III.	**Share Premium**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
IV.	**Revenue and other Reserves**		
	Opening Balance		
	Additions during the year		
	Deductions during the year		
V.	**Balance in Profit and loss Account**		
	Total : (I, II, III, IV and V)		

Schedule 3 - Deposits

			As on 31.3... (Current year)	As on 31.3... (Previous year)
A.	**I.**	**Demand Deposits**		
	(i)	***From banks***		
	(ii)	***From others***		
	II.	**Savings Bank Deposits**		
	III.	**Term Deposits**		
	(i)	***From Banks***		
	(ii)	***From others***		
		Total :(I, II and III)		
B.	(i)	Deposits of branches in India		
	(ii)	Deposits of branches outside India		
		Total		

Schedule 4 - Borrowings

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Borrowings in India**		
	(i) Reserve Bank of India		
	(ii) Other banks		
	(iii) Other institutions and agencies		
II.	**Borrowings outside India**		
	Total : (I and II)		
	Secured borrowings included in I & II above - ₹		

Schedule 5 - Other Liabilities and Provisions

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	Bills payable		
II.	Inter-office adjustments (net)		
III.	Interest accrued		
IV.	Others (including provisions)		
	Total		

Schedule 6 - Cash and Balances with Reserve Bank of India

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Cash in hand** (including foreign currency notes)		
II.	**Balances with Reserve Bank of India**		
	(i) In Current Account		
	(ii) In Other Accounts		
	Total : (I & II)		

Schedule 7 - Balances with Banks & Money at Call & Short Notice

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**In India**		
	(i) Balances with banks		
	(a) in Current Accounts		
	(b) in Other Deposit Accounts		
	(ii) Money at call and short notice		
	(a) with banks		
	(b) with other institutions		
	Total : (i & ii)		
II.	**Outside India**		
	(i) In Current Accounts		
	(ii) in other Deposits Accounts		
	(iii) Money at call and short notice		
	Total		
	Grand Total (I & II) :		

Schedule 8 - Investments

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Investments in India in**		
	(i) Government securities		
	(ii) Other approved securities		
	(iii) Shares		
	(iv) Debentures and Bonds		
	(v) Subsidiaries and/or joint ventures		
	(vi) Others (to be specified)		
	Total		
II.	**Investments outside India in**		
	(i) Government securities (Including local authorities)		

			As on 31.3.... (Current year)	As on 31.3.... (Previous year)
	(ii)	Subsidiaries and/or joint ventures abroad		
	(iii)	Other investments (to be specified)		
	Total			
	Grand Total :(I & II)			

Schedule 9 - Advances

			As on 31.3.... (Current year)	As on 31.3.... (Previous year)
A.	(i)	Bills purchased and discounted		
	(ii)	Cash credits, overdrafts and loans repayable on demand		
	(iii)	Term loans		
	Total			
B.	(i)	Secured by tangible assets		
	(ii)	Covered by Bank/Government Guarantees		
	(iii)	Unsecured		
	Total			
C.	**I.**	**Advances in India**		
	(i)	***Priority Sectors***		
	(ii)	***Public Sector***		
	(iii)	***Banks***		
	(iv)	***Others***		
		Total		
	II.	**Advances outside India**		
	(i)	***Due from banks***		
	(ii)	***Due from others***		
		(a) Bills purchased and discounted		
		(b) Syndicated loans		
		(c) Others		
	Total			
	Grand Total :(C. I & II)			

Schedule 10 - Fixed Assets

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	**Premises**		
	At cost as on 31st March of the preceding year		
	Additions during the year		
	Deductions during the year		
	Depreciation to date		
II.	**Other Fixed Assets** (including Furniture and Fixtures)		
	At cost as on 31st March of the preceding year		
	Additions during the year		
	Deductions during the year		
	Depreciation to date		
	Total : (I & II)		

Schedule 11 - Other Assets

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	Inter-office adjustments (net)		
II.	Interest accrued		
III.	Tax paid in advance/tax deducted at source		
IV.	Stationery and stamps		
V.	Non-banking assets acquired in satisfaction of claims		
VI.	Others*		
	Total		

*In case there is any unadjusted balance of loss the same may be shown under this item with appropriate foot-note.

Schedule 12 - Contingent Liabilities

		As on 31.3.... (Current year)	As on 31.3.... (Previous year)
I.	Claims against the bank not acknowledged as debts		
II.	Liability for partially paid investments		

III.	Liability on account of outstanding forward exchange contracts		
IV.	Guarantees given on behalf of constituents		
	(a) In India		
	(b) Outside India		
V.	Acceptances, endorsements and other obligations		
VI.	Other items for which the bank is contingently liable		
	Total		

Annexure II

Schedules forming part of Profit and Loss Account

Schedule 13 - Interest Earned

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Interest/discount on advances/bills		
II.	Income on investments		
III.	Interest on balances with Reserve Bank of India and other inter-bank funds		
IV.	Others		
	Total		

Schedule 14 - Other Income

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Commission, exchange and brokerage		
II.	Profit on sale of investments		
	Less : Loss on sale of investments		
III.	Profit on revaluation of investments		
	Less : Loss on revaluation of investments		
IV.	Profit on sale of land, building and other assets		

	Less : Loss on sale of land, building and other assets		
V.	Profit on exchange transactions		
	Less : Loss on exchange transactions		
VI.	Income earned by way of dividends etc. from subsidiaries/companies and/or joint ventures abroad/in India		
VII.	Miscellaneous Income		
	Total		

Note : Under items II to V loss figures may be shown in brackets.

Schedule 15 - Interest Expended

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Interest on deposits		
II.	Interest on Reserve Bank of India/inter-bank borrowings		
III.	Others		
	Total		

Schedule 16 - Operating Expenses

		Year ended 31.3.... (Current year)	Year ended 31.3.... (Previous year)
I.	Payments to and provisions for employees		
II.	Rent, taxes and lighting		
III.	Printing and stationery		
IV.	Advertisement and publicity		
V.	Depreciation on Bank's property		
VI.	Director's fees, allowances and expenses		
VII.	Auditor's fees and expenses (including branch auditor's fees and expenses)		
VIII.	Law Charges		
IX.	Postages, Telegrams, Telephones, etc.		

X. Repair and maintenance

XI. Insurance

XII. Other expenditure

Total

In 'Notes on Accounts', the following disclosures should be made:

Annexure III

Guidelines of Reserve Bank of India for Compliance of Financial Statements

Given below are the compliance notes of the Reserve Bank of India for balance sheet and profit and loss account as per the revised formats.

Balance Sheet

Item	*Schedule*	*Coverage*	*Notes and instructions for compilation*
Capital	1	**Nationalised Banks** (Fully Owned by Central Government)	The capital owned by Central Government as on the date of the Balance Sheet including contribution from Government, if any, for participating in World Bank Projects should be shown.
		Banking companies incorporated outside	(*i*) The amount brought in by banks by way of start-up capital as prescribed by RBI should be shown under this head.
		Other Banks (Indian) Authorised Capital (....Shares or ₹ each) Issued Capital (..Shares of ₹.....each) subscribed Capital (......Shares of ₹....each) Called up Capital (..........Shares of ₹.......each. Less : Calls unpaid........Add: Forfeited shares.....Paid up to capital.........	(*ii*) The amount of deposits kept with RBI, under sub-section 2 of section 11 of the Banking Regulation Act, 1949 should also be shown. Authorised, Issued, Subscribed, Called-up Capital should be given separately. Calls-in-arrears will be deducted from Called up capital while the paid-up value of forfeited shares should be added thus arriving at the paid-up capital. Where necessary, items which can be combined should be shown under one head for instance 'Issued and Subscribed Capital'. **Notes - General** The changes in the above items, if any, during the year, say, fresh contribution made by Government, fresh issue of capital, capitalisation of reserves, etc. may be explained in the notes.
Reserves and Surplus	2	**(I) Statutory Reserves**	Reserves created in terms of Section 17 or any other section of Banking Regulation Act must be separately disclosed.

		(II) Capital Reserves	The expression 'capital reserves' shall not include any amount regarded as free for distribution through the profit and loss account. Surplus on revaluation should be treated as Capital Reserves. Such reserves will have to be reflected on the face of the balance sheet as revaluation reserves. Surplus on translation of the financial statements of foreign branches (which includes fixed assets also) is not a revaluation reserve.
		(III) Share Premium	Premium on issue of share capital may be shown separately under this head.
		(IV) Revenue and other Reserves	The expression 'Revenue Reserve' shall mean any reserve other than capital reserve. This item created will include all reserves other than those separately classified. The expression Reserve shall not include any amount retained by way of providing renewals or diminution in value of assets or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability. Excess provision towards depreciation on investments should be transferred to 'Investment Fluctuations Reserve Account' which should be shown as a separate item under the head 'Revenue and Other Reserves'. The amount held in 'Investment Fluctuation Reserve Account' could be utilized to meet the depreciation requirement on investment in securities in future. Extra provision needed in the event of depreciation in the value of the investment should be debited to the Profit and Loss Account and if required, an equivalent amount may be transferred from the 'Investment Fluctuation Reserve Account' to the Profit and Loss Account as a 'below the line' item after determining the profit for the year.
		(V) Balance of Profit	Includes balance of profit after appropriations. In case of loss the balance may be shown as a deduction.

			Notes – General Movements in various categories of Reserves should be shown as indicated in the schedule
Deposits	3 **A.**	**(I)** **Demand Deposits** (i) from banks (ii) from others	Includes all bank deposits repayable on demand. Includes all demand deposits of the non-bank sectors. Credit balances in over-drafts, cash credit accounts, deposits payable at call, overdue deposits, inoperative current accounts, matured time deposits and cash certificates, certificates of deposits, etc. are to be included under this category.
		(II) **Saving Bank Deposits**	
		(III) **Term Deposits** (i) from banks	Includes all types of bank deposits repayable after a specified term.
		(ii) from others	Includes all types of deposits of the non-bank sector repayable after a specified term. Fixed deposits, cumulative and recurring deposits, cash certificates, certificates of deposits, annuity deposits, deposits mobilised under various schemes, ordinary staff deposits, foreign currency non-resident deposits accounts, etc. are to be included under this category.
	B.	(i) Deposits of branches in India (ii) Deposits of branches outside India	The total of these two items will agree with the total deposits. **Notes – General** (*a*) Interest payable on deposits which is accrued but not due should not be included but shown under other liabilities. (*b*) Matured time deposits and cash certifica-tes, etc. should be treated as demand deposits. (*c*) Deposits under special schemes should be included under term deposits if they are not payable on demand. When each deposits have matured for payments they should be shown under demand deposits.

			(*d*) Deposits from banks will include deposits from the banking system in India, co-operative banks, foreign banks which may or may not have a presence in India.
Borrowings	4	**(I) Borrowings in India**	
		(i) Reserve Bank of India	Includes borrowings/refinance obtained from Reserve Bank of India.
		(ii) Other banks	Includes borrowings/refinance obtained from commercial banks (including cooperative banks).
		(iii) Other institutions and agencies	Includes borrowings/refinance obtained from Industrial Development Bank of India. Export-Import Bank of India, National Bank for Agriculture and Rural Development and other institutions, agencies (including liability against participation certificates, if any)
		(II) Borrowings outside India	Includes borrowings of India branches abroad as well as borrowings of foreign branches.
		Secured borrowings included above	This item will be shown separately. Includes secured borrowings/refinance in India and outside India. **Notes – General** (*i*)The total of I & II will agree with the total borrowings shown in the balance sheet. (*ii*) Inter-office transactions should not be shown as borrowings. (*iii*) Funds raised by foreign branches by way of certificates of deposits, notes, bonds, etc. should be classified depending upon documentation, as 'deposits' 'borrowings', etc. (*iv*) Refinance obtained by banks from Reserve Bank of India and various institutions are being brought under the head 'Borrowings'. Hence, advances will be shown at the gross amount on the assets side
Other liabilities and provisions	5	**I.** Bills payable	Includes drafts, telegraphic transfers, travellers' cheques, mail transfers payable, pay slips, bankers cheques and other miscellaneous items.
		II. Inter-office adjustment (net)	The inter-office adjustments balance, if in credit, should be shown under this head. Only

				net position of inter-office accounts, inland as well as foreign, should be shown here. In working out the net position, credit entries outstanding for more than five years in inter-branch accounts should be segregated and transferred to a separate Blocked Account. While arriving at the net amount of inter-branch transactions for inclusion under Schedule 5 or 11 as the case may be, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries.
		III.	Interest accrued	Includes interest accrued but not due on deposits and borrowings.
		IV.	Others (including provisions)	(i) Includes the net provision for income tax and other taxes like interest tax (less advance payment tax deducted at source etc.), surplus in aggregate in provisions for bad debts provision account, surplus in aggregate in provisions for depreciation in securities, contingency funds which are not disclosed as a reserve but are actually in the nature of reserves, proposed dividend/ transfer to Government, other liabilities which are not disclosed under any of the major heads such as unclaimed dividend, provisions and fund kept for specific purposes, unexpired discount, outstanding charges like rent, conveyance etc. Certain types of deposits like staff security deposits, margin deposits, etc. where the repayment is not free, should also be included under this head. (ii) Provisions towards standard assets should be shown separately as 'Contingent Provisions against Standard Assets' under this ahead. (iii) Amount of subordinated debt raised as Tier II capital should be shown in Schedule 5 as well as by way of explanatory notes/remarks in the balance sheet. The Blocked Account arising from transfer of credit entries in inter-branch accounts outstanding for more than five years should be shown under this head. Any adjustment from the

			Blocked Account should be permitted only with the authorization of two officials one of whom should be from outside the branch concerned, preferably from the Controlling/Head Office if the amount exceeds Rupees one lakh. **Notes – General** (i) For arriving at the net balance of inter-office adjustments all connected inter-office accounts should be aggregated and the net balance only will be shown, representing mostly items in transit and unadjusted items. (ii)The interest accruing on all deposits, whether the payment is due or not, should be treated as a liability. (iii)It is proposed to show only pure deposits under this head 'deposits' and hence all surplus provisions for bad and doubtful debts, contingency funds, secret reserves, etc. which are not netted off against the relative assets, should be brought under the head 'Others (including provisions)'. (iv) The amount of subordinated debt raised against Tier II capital should be indicated.
Cash and Balances with the Reserve Bank of India	6	**I.** Cash in hand (including foreign currency notes) **II.** Balances with Reserve Bank of India (i) in Current Account (ii) in other Accounts	Includes cash in hand including foreign currency notes and also of foreign branches in case of banks having such branches.
Balances with banks and money at call and short notices	7	**I. In India** (i) Balances with banks (a) in current accounts (b) in other Deposit accounts	Includes all balances with banks in India (including co-operative banks). Balances in current accounts and deposit accounts should be shown separately.
		(ii) Money at call and short notice (a) with banks (b) with other institutions	Includes deposits repayable within 15 days or less than 15 days notice lent in the inter-bank call money market.

		II. Outside India (i) Current accounts (ii) Deposits accounts	Includes balances held by foreign branches and balances held by Indian branches of the banks outside India. Balances held with foreign branches by other branches of the bank should not be shown under this head but should be included in inter-branch accounts. The amounts held in 'current accounts' and 'deposit accounts' should be shown separately.
		(iii) Money at call and short notice	Includes deposits usually classified in foreign countries as money at call and short notice.
Investments	8	**I. Investments in India** (i) Government securities	Includes Central and State Government securities and Government treasury bills. These securities should be shown at the book value. However, the difference between the book value and market value should be given in the notes to the balance sheet.
		(ii) Other approved securities	Securities other than Government securities, which according to the Banking Regulation Act, 1949 are treated as approved securities*, should be included here.
		(iii) Shares	Investments in debentures and bonds of companies and corporations not included in item (*ii*) should be included here.
		(iv) Debentures and Bonds	Investments in debentures and bonds of and corporations not included in item (*ii*) should be included here.
		(v) Investments in subsidiaries/joint ventures	Investments in subsidiaries/joint ventures (including RRBs) should be included here.
		(vi) Others	Includes residual investments, if any, like gold, commercial paper and other instruments in the nature of shares/ debentures/ bonds.
		II. Investments outside India	
		(i) Government securities (including local	All foreign Government securities including securities issued by local authorities may be

* As per Banking Law Amendments Act, 2012 "Approved Securities" mean the securities issued by the Central Govt. or such securities as prescribed by RBI from time to time.

		authorities)	
		(ii) Subsidiary and/ or joint ventures abroad	All investments made in the share capital of subsidiaries floated outside India and/or joint ventures abroad should be classified under this head.
		(iii) Others	All other investments outside India may be shown under this head. *Notes-General* Indicate the gross value of investments in India and outside India, the aggregate of provisions for depreciation separately on investments in India and outside India, and the net value of investments in India and outside India, the total of which will be carried to balance sheet. The gross value of investments and provisions need not, however, be shown against each of the categories specified in the Schedule. The break-up of net value of investments in India and outside India (gross value of investments less provision) under each of the specified category need only be shown.
Advances	9 **A.**	(i) Bills purchased and discounted (ii) Cash credits, over-drafts and loans repayable on demand	In classification under section 'A'. All out standings in India as well as outside less provisions made, will be classified under three heads as indicated and both secured and unsecured advances will be included under these heads.
		(iii) Term loans	Including overdue installments.
	B.	(i) Secured by tangible assets (includes advances against book debts)	All advances or part of advances which are secured by tangible assets may be shown here. The item will include advances in India
		(ii) Covered by Bank/ Government Guarantee	Advances in India and outside India to the extent they are covered by guarantees of Indian and foreign governments and Indian and foreign banks and DICGC & ECGC are to be included.
		(iii) Unsecured	All advances not classified under (*i*) and (*ii*) will be included here. Total of 'A' should tally with the total of 'B'.
	C.	**I.** Advances in India	Advances should be broadly classified into

		(i) Priority sectors (ii) Public sector (iii) Banks (iv) Others **II.** Advances outside India (i) Due from banks (ii) Due from others	'Advances in India, and 'Advances outside India'. Advances in India will be further classified on the sectoral basis as indicated. Advances on sectors which for the time being are classified as priority sectors according to the instructions of the Reserve Bank are to be classified under the head 'Priority sector'. Such advances should be excluded from item (ii) *i.e.,* advances to public sector.
		(a) Bills purchased and discounted (b) Syndicate loans (c) Others	Advances to Central and State Governments and other Government undertaking including Government companies and corporations which are, according to the statutes, to be treated as public sector companies are to be included in the category "Public Sector". All advances to the banking sector including co-operative banks will come under the head 'Banks'. All the remaining advances will be included under the head 'Others' and typically this category will include non-priority advances to the private, joint and co-operative sectors. **Notes – General** (*i*) The gross amount of advances including refinance but excluding rediscounts provisions made to the satisfaction of auditors should be shown as advances. (*ii*) Term loans will be loans not repayable on demand. (*iii*) Consortium advances would be shown net of share from other participating banks/ institutions.
Fixed Assets	10	**I.** Premises (i) At cost as on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	Premises wholly or partly owned by the banking company for the purpose of business after the first balance sheet subsequent to the reduction or revaluation should show the revised figures for a period of five years with the date and amount of the revision made.
		II. Other Fixed	Motor vehicles and other fixed assets other

		Assets(including furniture and fixtures) (i) At cost on 31st March of the preceding year (ii) Additions during the year (iii) Deductions during the year (iv) Depreciation to date	than premises but including furniture and fixtures should be shown under this head.
Other Assets	11	**I.** Inter-office adjustments (net)	The inter-office adjustments balance, if in debit, should be shown under this head. Only net position of inter-office accounts, inland as well as foreign, should be shown here. For arriving at the net balances of inter-office adjustment accounts, all connected inter-office accounts should be aggregated and the net balance, if in debit, only should be shown representing mostly items in transit and unadjusted items. In working out the net position, credit entries outstanding for more than five years in inter-branch accounts should be segregated and transferred to a separate Blocked Account. While arriving at the net amount of inter-branch transactions for inclusion under Schedule 5 or 11, as the case may be, the aggregate amount of Blocked Account should be excluded and only the amount representing the remaining credit entries should be netted against debit entries.
		II. Interest accrued	Interest accrued but not due on investments and advances and interest due but not collected on investments will be the main components of this item. As banks normally debit the borrowers' accounts with interest due on the balance sheet date, usually there may not be any amount of interest due on advances. Only such interest as can be realised on the ordinary course should be shown under this head.
		III. Tax paid in advance/tax deducted at source	The amount of tax deducted at source on securities, advance tax paid etc. to the extent that these items are not set off against relative tax provisions should be shown against this item.

		IV. Stationery and stamps	Only exceptional items of expenditure on stationery like bulk purchase of securities paper, loose leaf or other ledgers, etc. which are shown as quasi-asset to be written off over a period of time should be shown here. The value should be on a realistic basis and cost escalation should not be taken into account, as these items are for internal use.
		V. Non-banking assets acquired in satisfaction of claims.	Immovable properties/tangible assets acquired in satisfaction of claims are to be shown under this head.
		VI. Others	This will include items like claims which have not been met, for instance, clearing items, provision netted against this item so that only realisable value is shown under this head. Accrued income other than interest may also be included here. Outstanding in credit card operations should be shown as part of "advances" (Schedule instead of clubbing these under "Other Assets"
Contingent Liabilities	12	**I.** Claims against the bank not acknowledged as debts	
		II. Liability for partly paid investments	Liability on partly paid shares, debentures, etc. will be included under this head.
		III. Liability on account of outstanding forward exchange contracts	Outstanding forward exchange contracts may be included here.
		IV. Guarantees given on behalf of constituents (i) In India (ii) Outside India	Guarantees given for constituents in India and outside India may be shown separately.
		V. Acceptances endorsements and other obligations	This item will include letters of credit and bills accepted by the bank on behalf of customers.
		VI. Other items for which the Bank is contingently liable	Arrears of cumulative dividends, bills rediscounted, commitments under under-writing contracts, estimated amounts of contracts remaining to be executed on capital account and not provided for, etc. are to be included here.

Bills for Collection			Bills and other items in the course of collection and not adjusted will be shown against this item in the summary version only. No separate schedule is proposed.

Profit and Loss Account

Interest earned	13	**I.** Interest/discount on advances/bills	Includes interest and discount on all types of loans and advances like cash credit, demand loans, overdraft, export loans, term loans, domestic and foreign bills purchased and discounted (including those rediscounted), overdue, interest and also interest subsidy, if any, relating to such advances/bills.
		II. Income on Investments	Includes all income derived from the investment portfolio by way of interest and dividend
		III. Interest on balances with Reserve Bank of India and other Interbank funds	Includes interest on balances with Reserve Bank and other banks, call loans, money market placements, etc.
		IV. Others	Includes any other interest/discount income not included in above heads.
Other Income	14	**I.** Commission, exchange and brokerage	Includes all remuneration on services such as commission on collections, commission/exchange on remittances and transfers, commission on letter of credit and guarantees, commission on Government business commission on other permitted agency business including consultancy and other services, broke-rage, etc. on securities. It does not include foreign exchange income.
		II. Profit on sale of investments Less Loss on sale of investments	Includes profit/loss on sale of securities, furniture land and buildings, motor of vehicle, gold, silver etc.. Only the net position should be shown. If the net position is a loss, the amount should be shown as deduction.
		III. Profit on revaluation of investments Less: Loss on revaluation of investments	The net profit/loss on revaluation of assets may also be shown under this item.

		IV. Profit on sale of land, building and other assets Less : Loss on sale of land, buildings and other assets	
		V. Profit on exchange transactions Less : Loss on exchange transactions **VI.** Income earned by way of dividends etc. from subsidiaries, companies and/or joint ventures abroad/in India	Includes profit/loss on dealing in foreign exchange all income earned by way of foreign exchange commission and charges on foreign exchange, transactions excluding interest which will be shown under interest. Only the net position should be shown. If the net position is a loss, it is to be shown as a deduction.
		VII. Miscellaneous income	Includes recoveries from constituents for the godown rents, income from bank's properties, security charges, insurance etc. and any other miscellaneous income. In case any item under this head exceeds one percentage of the total income, particulars may be given in the notes.
Interest Expended	15	**I.** Interest on deposits	Includes interest paid on all types of deposits including deposits from banks and others institutions.
		II. Interest on Reserve Bank of India/inter-bank borrowings	Includes discount/interest on all borrowings and refinance from Reserve Bank of India and other banks.
		III. Others	Includes discount / interest on all borrowings/refinance from financial institutions. All otherpayments like interest on participation certificates, penal interest paid, etc. may also be included here.
Operating expenses	16	**I.** Payments to and Provisions for employees	Includes staff salaries / wages, allowances, bonus, other staff benefits like provident fund, pension, gratuity liveries to staff, leave fare concessions, staff welfare, medical allowance to staff etc.
		II. Rent, taxes and lighting	Includes rent paid by the banks on building and other municipal and other taxes paid (excluding income tax and interest tax) electricity and other similar charges and levies. House rent allowance and other similar payments to staff should appear

			under the head 'Payments to and provisions for employees'.
		III. Printing and Stationery	Includes books and forms and stationery used by the bank and other printing charges which are not incurred by way of publicity expenditure.
		IV. Advertisement and publicity	Includes expenditure incurred by the bank for advertisement and publicity purposes including printing charges of publicity matter.
		V. Depreciation on Bank's property	Includes depreciation on bank's own property: motor cars and other vehicles, furniture, electric fittings, vaults, lifts, leasehold properties, non banking assets, etc.
		VI. Directors' fees, allowances and expenses	Includes sitting fees and all other items of expenditure incurred on behalf of directors. The daily allowances, hotel charges, conveyance charges, etc. which though in the nature of reimbursement of expenses incurred may be included under this head. Similar expenses of local Committee members may also be included under this head.
		VII. Auditors' fees and expenses (including branch auditors' fees and expenses)	Includes fees paid to the statutory auditors and branch auditors for professional services rendered and all expenses for performing their duties, even though they may be in the nature of reimbursement of expenses. If external auditors have been appointed by banks themselves for internal inspections and audits and other services the expenses incurred in that context including fees may not be included under this head but shown under 'other expenditure'.
		VIII. Law charges	All legal expenses and reimbursement of expenses incurred in connection with legal services are to be included here.
		IX. Postage, telegrams, telephones, etc.	Includes all postal charges like stamps, tele-gram, telephones, teleprinter, etc.
		X. Repairs and maintenance	Includes repairs to banks' property, their maintenance charges, etc..

		XI. Insurance	Includes insurance charges on bank's property, insurance premium paid to Deposit Insurance & Credit Guarantee Corporation, etc. to the extent they are not recovered from the concerned parties.
		XII. Other expenditure	All expenses other than those not included in any of the other heads like, licence fees, donations, subscriptions to papers, periodicals, entertainment expenses, travel expenses, etc. may be included under this head. In case any particular item under this head exceeds one percentage of the total income particulars may be given in the notes.
Provisions and contingencies			Includes all provisions made for bad and doubtful debts, provisions for taxation, provisions for diminution in the value of investments, transfers to contingencies and other similar items.
Treatment of accumulated losses			While preparing the Balance Sheet and Profit and Loss Account accumulated losses should be brought forward under Item III or Form "B" before appropriation of the balance profit made.

Annexure IV

Risk Weights for Calculation of Capital charge for Credit Risk

The following table shows the weights to be assigned to the value of different assets and off-balance sheet items:

I. Domestic Operations

A. Funded Risk Assets

Sr. No.	Item of asset or liability	Risk Weight %
I	**Balances**	
1.	Cash, balances with RBI	0
2.	i. Balances in current account with other banks	20
	ii. Claims on Bank	20
II	**Investments (Applicable to securities held in HTM)**	
1.	Investments in Government Securities.	0

2.	Investments in other approved securities guaranteed by Central! State Government. Note: If the repayment of principal / interest in respect of State Government Guaranteed securities included in item 2, 4 and 6 has remained in default, for a period of more than 90 days banks should assign 100% risk weight. However the banks need to assign 100% risk weight only on those State Government guaranteed securities issued by the defaulting entities and not on all the securities issued or guaranteed by that State Government.	0
3.	Investments in other securities where payment of interest and repayment of principal are guaranteed by Central Govt. (This will include investments in Indira/Kisan Vikas Patra (IVP/KVP) and investments in Bonds and Debentures where payment of interest and principal is guaranteed by Central Govt.)	0
4.	Investments in other securities where payment of interest and repayment of principal are guaranteed by State Governments.	0
5.	Investments in other approved securities where payment of interest and repayment of principal are not guaranteed by Central/State Govt.	20
6.	Investments in Government guaranteed securities of Government Undertakings which **do not** form part of the approved market borrowing programme.	20
7.	Claims on commercial banks. Note: The exposure of Indian branches of foreign banks, guaranteed/ counter-guaranteed by overseas Head Offices or the bank's branch in other country, would amount to a claim on the parent foreign bank and the risk weight of such exposure would depend upon the rating (assigned by the international rating agencies) of the overseas parent of the Indian branch.	20
8.	Investments in bonds issued by other banks	20

9.	Investments in securities which are guaranteed by banks as to payment of interest and repayment of principal.	20
10.	Investments in subordinated debt instruments and bonds issued by other banks or Public Financial Institutions for their Tier II capital.	100
11 .	Deposits placed with SIDBI/NABARD in lieu of shortfall in lending to priority sector.	100
12.	Investment in Mortgage Backed Securities (MBS) of residential assets of Housing Finance Companies (HFCs) which are recognised and supervised by National Housing Bank	50
13	Investment in Mortgage Backed Securities (MBS) which are backed by housing loan qualifying for 50% risk weight.	50
14.	Investment in securitised paper pertaining to an infrastructure facility.	50
15	Investments in debentures/ bonds/ security receipts/ Pass Through Certificates issued by Securitisation Company / SPVs/ Reconstruction Company and held by banks as investment	100
16.	All other investments including investments in securities issued by PFIs.	100
	Note: Equity investments in subsidiaries, intangible assets and losses deducted from Tier I capital should be assigned zero weight	
17	Direct investment in equity shares, convertible bonds, debentures and units of equity oriented mutual funds	125
18	Investment in Mortgaged Backed Securities and other securitised exposures to Commercial Real Estate	150
19	Investments in Venture Capital Funds	150
20	Investments in Securities issued by SPVs (in respect of securitisation of standard assets) underwritten and devolved on originator banks during the stipulated period of three months	100
21	Investments in Securities issued by SPVs in respect of securitisation of standard asset underwritten and devolved on bank as third party service provider during the stipulated period of three months	100
22	NPA Investment purchased from other banks	100

23	Investments in instruments issued by NBFC-ND-SI	100
III	**Loans & Advances** including bills purchased and discounted and other credit facilities	
1.	Loans guaranteed by Govt. of India Note: The amount outstanding in the account styled as "Amount receivable from Government of India under Agricultural debt Waiver Scheme 2008" shall be treated as a claim on the Government of India and would attract zero risk weight for the purpose of capital adequacy norms. However, the amount outstanding in the accounts covered by the Debt Relief Scheme shall be treated as a claim on the borrowers and risk weighted as per the extant norms.	0
2.	Loans guaranteed by State Govts. Note: If the loans guaranteed by State Govts. have remained in default for a period of more than 90 days a risk weight of 100 percent should be assigned.	0
3.	Loans granted to public sector undertakings of Govt. of India	100
4.	Loans granted to public sector undertakings of State Govt.	100
	(i) For the purpose of credit exposure, bills purchased/discounted	
5.	/negotiated under LC (where payment to the beneficiary is not under reserve) is treated as an exposure on the LC issuing bank and assigned risk weight as is normally applicable to inter-bank exposures.	20
	(ii) Bills negotiated under LCs 'under reserve', bills purchased/discounted/negotiated without LCs, will be reckoned as exposure on the borrower constituent. Accordingly, the exposure will attract a risk weight appropriate to the borrower. (i) Govt.	
	(ii) Banks	20
	(iii) Others	100
6.	Others including PFIs	100
7.	Leased Assets	100

8.	Advances covered by DICGC/ECGC Note: The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstandings in excess of the amount guaranteed, will carry 100% risk weight.	50
9.	SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI) up to the guaranteed portion. **Note:** Banks may assign zero risk weight for the guaranteed portion. The balance outstanding in excess of the guaranteed portion would attract a risk-weight as appropriate to the counter- party.	0
10.	Insurance cover under Business Credit Shield, the product of New India Assurance Company Ltd. ***Note:*** The risk weight of 50% should be limited to the amount guaranteed and not the entire outstanding balance in the accounts. In other words, the outstandings in excess of the amount guaranteed, will carry 100% risk weight.	50
11 12.	Advances against term deposits, Life policies, NSCs, IVPs and KVPs where adequate margin is available. Loans and Advances granted to staff of banks which are fully covered by superannuation benefits and mortgage of flat/house.	0 20
13.	Housing loans above ₹30 lakh sanctioned to individuals against the mortgage of residential housing properties having LTV ratio equal to or less than 75% Note: If restructured	75 100
14	Housing loans upto ₹30 lakhs sanctioned to individuals against the mortgage of residential housing properties having LTV ratio equal to or less than 75%. Note: If restructured	50 75
15	Housing loans of ₹ 75 lakhs and above sanctioned to individuals (irrespective of LTV ratio)	125

16	Consumer credit including personal loans and credit cards	125
16A	Educational Loans	100
17	Loans up to ₹.1 lakh against gold and silver ornaments	50
18	Takeout Finance	
	(i) Unconditional takeover (in the books of lending institution) (a) Where full credit risk is assumed by the taking over institution (b) Where only partial credit risk is assumed by taking over institution i) the amount to be taken over ii) the amount not to be taken over	20 20 100
	(ii) Conditional take-over (in the books of lending and Taking over institution)	100
19	Advances against shares to individuals for investment in equity shares (including IPOs/ESOPs), bonds and debentures, units of equity oriented mutual funds, etc.	125
20	Secured and unsecured advances to stock brokers	125
21	Fund based exposures commercial real estate*	100
22	Funded liquidity facility for securitisation of standard asset transactions	100
23	NPA purchased from other banks	100
24	Loans & Advances NBFC-NO-SI (other than Asset Finance Companies (AFCs)) &	100
25	All unrated claims on corporate, long term as well as short term, regardless of the amount of the claim	100
IV	**Other Assets**	
1.	Premises, furniture and fixtures	100
2.	Income tax deducted at source (net of provision)	0
	Advance tax paid (net of provision)	0
	Interest due on Government securities	0
	Accrued interest on CRR balances and claims on RBI on account of Government transactions (net of claims of	0

	Government/RBI on banks on account of such transactions)	
	All other assets #	100

i) The exposures to CCPs on account of derivatives trading and securities financing transactions (e.g. CBIOs, Repos) outstanding against them, will be assigned zero exposure value for counterparty credit risk, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the CCP's credit risk exposures;

ii) The deposits / collaterals kept by banks with the CCPs will attract risk weights appropriate to the nature of the CCP. In the case of CCIl, the risk weight will be 20 per cent and for other CCPs, it will be according to the ratings assigned to these entities as per the New Capital Adequacy Framework.

& As regards claims on AFCs, there is no change in the risk weights, which would continue to be governed by the credit rating of the AFC, except the claims that attract a risk weight of 150 per cent under the New Capital Adequacy Framework, which shall be reduced to a level of 100 per cent.

* It is possible for an exposure to get classified simultaneously into more than one category, as different classifications are driven by different considerations. In such cases, the exposure would be reckoned for regulatory / prudential exposure limit, if any, fixed by RBI or by the bank itself, for all the categories to which the exposure is assigned. For the purpose of capital adequacy, the largest of the risk weights applicable among all the categories would be applicable for the exposure.

Off-Balance Sheet Items

The credit risk exposure attached to off-Balance Sheet items has to be first calculated by multiplying the face value of each of the off-Balance Sheet items by 'credit conversion factor' as indicated in the table below. This will then have to be again multiplied by the weights attributable to the relevant counter-party as specified above.

S No.	Instruments	Credit conversion factor
1.	Direct credit substitutes e.g. general guarantees of indebtedness*	100
(i)	Guarantees for credit facilities	
(ii)	Guarantees in lieu of repayment of financial securities;	
(iii)	Guarantees in lieu of margin requirements of exchanges;	

(iv)	Guarantees for mobilisation advance, advance money before the commencement of a project and for money to be received in various stages of project implementation;	
(v)	Guarantees towards revenue dues, taxes, duties, levies etc. in favour of Tax/ Customs / Port / Excise Authorities and for disputed liabilities for	
(vi)	Credit Enhancements;	
(vii)	Liquidity facilities for securitisation transactions;	
(viii)	Acceptances (including endorsements with the character of acceptance);	
(ix)	Deferred payment guarantees.	
2.	Certain transaction-related contingent items(performance Guarantees)*	50
(i)	Bid bonds;	
(ii)	Performance bonds and export performance guarantees;	
(iii)	Guarantees in lieu of security deposits / earnest money deposits (EMD) for participating in tenders;	
(iv)	Retention money guarantees;	
(v)	Warranties, indemnities and standby letters of credit related to particular transaction.	
3.	Short-term self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments).	20
4.	Sale and repurchase agreement and asset sales with recourse the credit risk remains with the bank., where	100
5.	Forward asset purchases, forward deposits and partly paid shares and securities, which represent commitments with certain drawdown.	100
6.	Note issuance facilities and revolving underwriting facilities.	50
7.	Other commitments (e.g., formal standby facilities and credit lines) with an original maturity of over one year.	50
8.	Similar commitments with an original maturity upto one year, or which can be unconditionally cancelled at any time.	0

* An indicate list of financial and performance guarantees given under circular no. DBOD. No. BP. BC.89.21.04.009 dated April 2, 2013.

9.	Aggregate outstanding foreign exchange contracts of original maturity -	
	• less than one year	2
	• for each additional year or part thereof	3
10.	Take-out Finance in the books of taking-over institution	
	(i) Unconditional take out finance	100
	(ii) Conditional take out finance	50
	Note: As the counter-party exposure will determine the risk weight, it will be 100 percent in respect of all borrowers or zero percent if covered by Government guarantee.	
11	Non-Funded exposures to commercial real estate	150
12	Guarantees issued on behalf of stock brokers and market makers	125
13	Commitment to provide liquidity facility for secuitisation of standard asset transactions	100
14	Second loss credit enhancement for securitisation of standard asset transactions provided by third party	100
15	Non-funded exposure to NBFC-ND-SI	125

NOTE: In regard to *off-balance* sheet items, the following transactions with non-bank counterparties will be treated as claims on banks and carry a risk-weight of 20%

- Guarantees issued by banks against the counter guarantees of other banks.
- Rediscounting of documentary bills accepted by banks. Bills discounted by banks which have been accepted by another bank will be treated as a funded claim on a bank.

In all the above cases banks should be fully satisfied that the risk exposure is in fact on the other bank.

Risk weights for Open positions

Sr. No.	**Item**	**Risk weight (%)**
1.	Foreign exchange open position.	100
2.	Open position in gold *Note:* The risk weighted position both in respect of foreign exchange and gold open position limits should be added to the other risk weighted assets for calculation of CRAR	100

I.D. Risk weights for Forward Rate Agreement (FRA) / Interest Rate Swap (IRS)

For reckoning the minimum capital ratio, the computation of risk weighted assets on account of FRAs/IRS should be done as per the two steps procedure set out below:

Step 1

The notional principal amount of each instrument is to be multiplied by the conversion factor given below:

Original Maturity	Conversion Factor
Less than one year	0.5 per cent
One year and less than two years	1.0 per cent
For each additional year	1.0 per cent

Step 2

The adjusted value thus obtained shall be multiplied by the risk weightage allotted to the relevant counter-party as specified below:

Counter party	Risk weight
Banks	20 percent
Central & State Govt.	0 percent
All others	100 percent

II. Overseas operations (applicable only to Indian banks having branches abroad)

A. Funded Risk Assets

Sr. No.	Item of asset or liability	Risk %
i)	Cash	0
ii)	Balances with Monetary Authority	0
iii)	Investments in Government securities	0
iv)	Balances in current account with other banks	20
v)	All other claims on banks including but not limited to funds loaned in money markets, deposit placements, investments in CDs/FRNs. Etc.	20
vi)	Investment in non-bank sectors	100
vii)	Loans and advances, bills purchased and discounted and other credit facilities	
	a) Claims guaranteed by Government of India.	0
	b) Claims guaranteed by State Governments	0

	c) Claims on public sector undertakings of Government of India.	100
	d) Claims on public sector undertakings of State Governments	100
	e) Others	100
viii)	All other banking and infrastructural assets	100

B. Non-funded risk assets

Sr. No.	Instruments	Credit Conver Factor
i)	Direct credit substitutes, e.g. general guarantees of indebtedness (including standby letters of credit serving as financial guarantees for loans and securities) and acceptances (including endorsements with the character of acceptances)	100
ii)	Certain transaction-related contingent items (e.g. performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions)	50
iii)	Short-term self-liquidating trade related contingencies- such as documentary credits collateralised by the underlying shipments	20
iv)	Sale and repurchase agreement and asset sales with recourse, where the credit risk remains with the bank.	100
v)	Forward asset purchases, forward deposits and partly paid shares securities, which represent commitments with certain draw down	100
vi)	Note issuance facilities and revolving underwriting facilities	50
vii)	Other commitments (e.g. formal standby facilities and credit lines) with an original maturity of over one year.	50
viii)	Similar commitments with an original maturity up to one year, or which can be unconditionally cancelled at any time.	0

SSI Advances Guaranteed by Credit Guarantee Fund Trust for Small Industries (CGTSI) - Risk weights and Provisioning norms

Risk-weight Example I

CGTSI Cover: 75% of the amount outstanding or 75% of the unsecured amount or ₹18.75 lakh . whichever is less

Realisable value of Security

a)	Balance outstanding	: ₹1.50 lakh
b)	Realisable value of security	: ₹ 10.00 lakh
c)	Unsecured amount (a) - (b)	: ₹ 1.50 lakh
d)	Guaranteed portion (75% of (c)	: ₹ 6.38 lakh
e)	Uncovered portion (8.50 lakh - 6.38 lakh)	: ₹ 2.12 lakh
	Risk-weight on (b) and (e)	- Linked to the counter party
	Risk-weight on (d)	- Zero

Example II

CGTSI cover : 75% of the amount outstanding or 75% of the unsecured amount or ₹ 18.75 lakh whichever is less

Realisable value of Security		*: ₹ 10.00 lakh.*
a)	*Balance outstanding*	*: ₹ 40.00 lakh*
b)	*Realisable value of security*	*: ₹ 10.00 lakh*
c)	*Unsecured amount (a) - (b)*	*: ₹ 30.00 lakh*
d)	*Guaranteed portion (max.)*	*: ₹ 18.75 lakh*
e)	*Uncovered portion (₹ 30 lakh-18.75 lakh)*	*: ₹ 11.25 lakh*
Risk-weight (b) and (e)		*- Linked to the counter party*
Risk-weight on (d)		*- Zero*

7

Departmental Accounts

Learning Objectives

After studying this chapter, you will be able to:

- Allocate common expenditures of the organization among various departments on appropriate basis.
- Deal with the inter-departmental transfers and their accounting treatment.
- Calculate the amount of unrealized profit on unsold inter-departmental stock-in-hand at the end of the accounting year.
- Work on problems based on inter-departmental transfers at profit and calculation of unrealized profit on the remaining stock at the end of the accounting year.

1. Introduction

If a business consists of several independent activities, or is divided into several departments, for carrying on separate functions, its management is usually interested in finding out the working results of each department to ascertain their relative efficiencies. This can be made possible only if departmental accounts are prepared. Departmental accounts are of great help and assistance to the managements as information for controlling the business more intelligently and effectively, since thereby all types of waste either of material or of money are readily detected; also attention is drawn to inadequacies or inefficiencies in the working of departments or units into which the business may be divided.

2. Advantages of Departmental Accounting

The main advantages of departmental accounting are as follows:

1. ***Evaluation of performance:*** The performance of each department can be evaluated separately on the basis of trading results. An endeavour may be made to push up the sales of that department which is earning maximum profit.
2. ***Growth potential of each department:*** The growth potential of a department as compared to others can be evaluated.

3. ***Justification of capital outlay:*** It helps the management to determine the justification of capital outlay in each department.

4. ***Judgement of efficiency:*** It helps to calculate stock turnover ratio of each department separately, and thus the efficiency of each department can be revealed.

5. ***Planning and control:*** Availability of separate cost and profit figures for each department facilitates better control. Thus effective planning and control can be achieved on the basis of departmental accounting information.

Basically, an organization usually divides the work in various departments, which is done on the principle of division of labour. This can improve efficiency of each and every department of the organization. Each department prepares its separate accounts to judge its individual performance.

3. Methods of Departmental Accounting

There are two methods of keeping departmental accounts:

3.1 Accounts of all departments are kept in one book only: To prepare such accounts, it will be necessary first, for the income and expenditure of department to be separately recorded in subsidiary books and then for them to be accumulated under separate heads in a ledger or ledgers. This may be done by having columnar subsidiary books and a columnar ledger. ***Under this system, the gross profit of individual department can be determined accurately.***

3.2 Separate set of books are kept for each department: A separate set of books may be kept for each department, including complete stock accounts of goods received from or transferred to other departments or as also sales.

Nevertheless, even when separate sets of books are maintained for different departments, it will also be necessary to devise a basis for allocation of common expenses among the different departments, if an organisation is interested in determining the separate departmental net profit in addition to the gross profit.

4. Basis of Allocation of Common Expenditure among different Departments

Expenses should be allocated among different departments on a rational basis while preparing departmental accounts.

Individual Identifiable Expenses: Expenses incurred specially for a particular department are charged directly thereto, *e.g.,* insurance charges of stock held by a department.

Common Expenses: Common expenses, the benefit of which is shared by all the departments and which are capable of precise allocation are distributed among the departments concerned on some equitable basis considered suitable in the circumstances of the case.

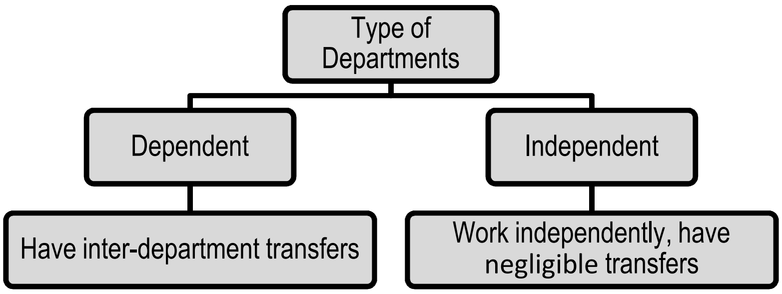
Allocation of Expenses

S.No.	*Expenses*	*Basis*
1.	Rent, rates and taxes, repairs and maintenance, insurance of building	Floor area occupied by each department (if given) other wise on time basis
2.	Lighting and Heating expenses (eg. energy expenses)	Consumption of energy by each department
3.	Selling expenses, *e.g.,* discount, bad debts, selling commission, freight outward, travelling sales manager's salary and other costs	Sales of each department
4.	Carriage inward/ Discount received	Purchases of each department
5.	Wages/Salaries	Time devoted to each department
6.	Depreciation, insurance , repairs and maintenance of capital assets	Value of assets of each department otherwise on time basis
7.	Administrative and other expenses, *e.g.,* salaries of managers, directors, common advertisement expenses, etc.	Time basis or equally among all departments
8.	Labour welfare expenses	Number of employees in each department
9.	PF/ESI contributions	Wages and salaries of each department

Note: *There are certain expenses and income, most being of financial nature, which cannot be apportioned on a suitable basis; therefore they are recognised in the combined Profit and Loss Account for example-interest on loan, profit/loss on sale of investment etc.*

5. Types of Departments

There are two types of departments.



5.1 Independent Departments: Departments which work independently of each other and have negligible inter department transfer are called Independent Departments.

5.2 Dependent Departments: Departments which transfer goods from one department to another department for further processing are called dependent departments. Here, the output of one department becomes the input for the other department. These transfers may be done at cost or some pre-decided selling price. The price at which this is done is known as transfer price. In these departments unloading is required if the transfer price is having profit element. The method of eliminating unrealized profit is being discussed in the succeeding para 6.2.

6. Inter-departmental Transfers

Whenever goods or services are provided by one department to another, their cost should be separately recorded and charged to the department benefiting thereby and credited to that providing it. The totals of such benefits should be disclosed in the departmental Profit and Loss Accounts, to distinguish them from other items of expenditure.

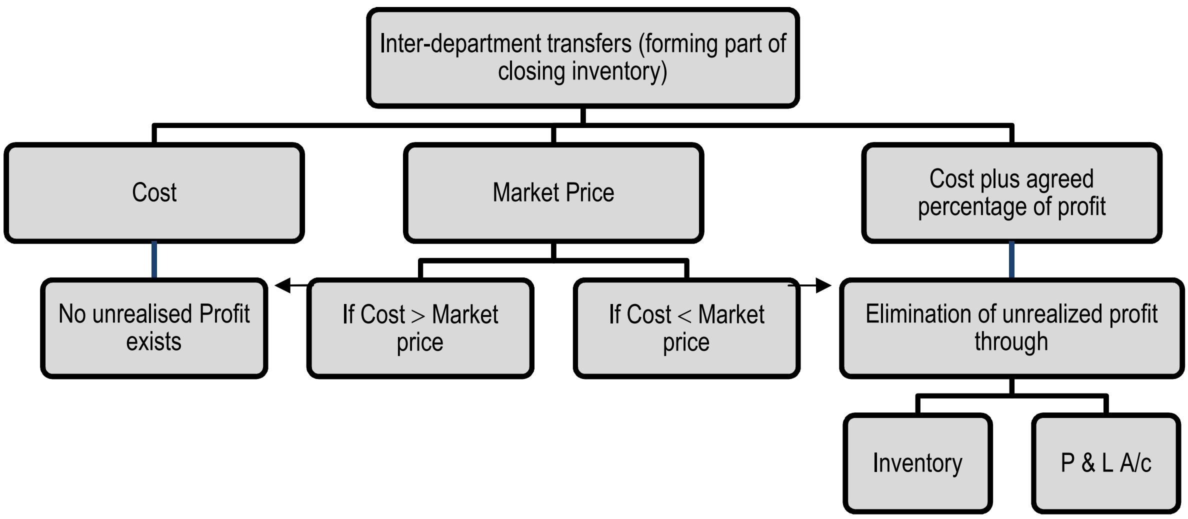
6.1 Basis of Inter-Departmental Transfers: Goods and services may be charged by one department to another usually on either of the following three bases:

(*i*) Cost,

(*ii*) Ruling market price,

(*iii*) Cost *plus* agreed percentage of profit.

6.2 Elimination of Unrealized Profit: When profit is added in the inter-departmental transfers the loading included in the unsold stock at the end of the year is to be excluded before final accounts are prepared so as to eliminate any anticipatory profit included therein.



6.3 Stock Reserve: Unrealized profit included in unsold inventory at the end of accounting period is eliminated by creating an appropriate stock reserve by debiting the combined Profit and Loss Account. The amount of stock reserve will be calculated as:

$$\frac{\text{Transfer price of unsold stock} \times \text{Profit included in transfer price}}{\text{Transfer price}}$$

6.4 Journal Entry: At the end of the accounting year, the following journal entry will be passed for elimination of unrealized profit (creation of stock reserve):

Profit and Loss Account Dr.

To Stock Reserve

(Being a provision made for unrealized profit included in closing inventory)

In the beginning of the next accounting year, the aforesaid journal entry will be reversed as under:

Stock Reserve Dr.

To Profit and Loss Account

(Being provision for unrealized profit reversed.)

6.5 Disclosure in Balance Sheet: The unsold closing inventory acquired from another department will appear on the assets side of the balance sheet as under:

(An extract of the assets side of the balance sheet)

Current assets	xxx
Inventory	xxx
Less: Stock reserve	xxx
	xxx

7. Memorandum Stock and Memorandum Mark up Account Method

Under this method, goods supplied to each department are debited to a Memorandum Departmental Stock account at cost plus a 'mark up' (loading) to give the normal selling price of the goods. The sale proceeds of the department are credited in Memorandum Departmental Stock account and amount of 'Mark up' is credited to the Departmental Mark up Account. When it is necessary to reduce the selling price below the normal selling price, i.e., cost plus mark up, the reduction (mark down) is entered in the Memorandum Stock account as well as in the Mark up account. This method helps to achieve effective control of stock movements of various departments.

8. Miscellaneous Illustrations

Illustration 1

M/s Omega is a departmental store having three departments X, Y and Z. The information regarding three departments for the year ended 31st March, 2013 are given below:

	X	Y	Z
	₹	₹	₹
Opening Stock	36,000	24,000	20,000
Purchases	1,32,000	88,000	44,000
Debtors at end	15,000	10,000	10,000
Sales	1,80,000	1,35,000	90,000
Closing stock	45,000	17,500	21,000
Value of furniture in each department	20,000	20,000	10,000
Floor space occupied by each department (in sq. ft.)	3,000	2,500	2,000
Number of employees in each Department	25	20	15
Electricity consumed by each department (in units)	300	200	100

The balances of other revenue items in the books for the year are given below:

	Amount (₹)
Carriage inwards	3,000
Carriage outwards	2,700
Salaries	48,000
Advertisement	2,700
Discount allowed	2,250
Discount received	1,800
Rent, Rates and Taxes	7,500
Depreciation on furniture	1,000
Electricity expenses	3,000
Labour welfare expenses	2,400

You are required to prepare Departmental Trading and Profit and Loss Account for the year ended 31st March, 2013 after providing provision for Bad Debts at 5%.

Solution

In the Books of M/s Omega
Departmental Trading and Profit and Loss Account
for the year ended 31st March, 2013

Particulars	*Deptt.X*	*Deptt.Y*	*Deptt.Z*	*Total*	*Particulars*	*Deptt.X*	*Deptt.Y*	*Deptt.Z*	*Total*
	₹	₹	₹	₹		₹	₹	₹	₹
To Stock	36,000	24,000	20,000	80,000	By Sales	1,80,000	1,35,000	90,000	4,05,000
To Purchases	1,32,000	88,000	44,000	2,64,000	By Stock	45,000	17,500	21,000	83,500
To Carriage Inwards	1,500	1,000	500	3,000					
To Gross Profit c/d	55,500	39,500	46,500	1,41,500					
	2,25,000	1,52,500	1,11,000	4,88,500		2,25,000	1,52,500	1,11,000	4,88,500
To Carriage Outwards	1,200	900	600	2,700	By Gross Profit b/d	55,500	39,500	46,500	1,41,500
To Electricity	1,500	1,000	500	3,000	By Discount received	900	600	300	1,800
To Salaries	20,000	16,000	12,000	48,000					
To Advertisement	1,200	900	600	2,700					
To Discount allowed	1,000	750	500	2,250					
To Rent, Rates and Taxes	3,000	2,500	2,000	7,500					
To Depreciation	400	400	200	1,000					
To Provision for Bad Debts	750	500	500	1,750					
To Labour welfare expenses	1,000	800	600	2,400					
To Net Profit	26,350	16,350	29,300	72,000					
	56,400	40,100	46,800	1,43,300		56,400	40,100	46,800	1,43,300

Working Note:

Basis of allocation of expenses	
Carriage inwards	Purchases (3:2:1)
Carriage outwards	Turnover (4:3:2)
Salaries	No. of Employees (5:4:3)
Advertisement	Turnover (4:3:2)
Discount allowed	Turnover (4:3:2)
Discount received	Purchases (3:2:1)
Rent, Rates and Taxes	Floor Space occupied (6:5:4)
Depreciation on furniture	Value of furniture (2:2:1)
Labour welfare expenses	No. of Employees (5:4:3)
Electricity expense	Units consumed (3:2:1)
Provision for bad debts	Debtors balances (3:2:2)

Illustration 2

Messrs D, B and R carried on a business of Drapers and Tailors in Delhi; D was incharge of Department "A" dealing in cloth, B of department "B" for selling garments and R of Department "C" the tailoring section. It had been agreed that each of the three partners would receive 75% of the profits disclosed by the accounts of the department of which he was incharge and the balance of the combined profits would be shared in the proportion: D 1/2, B 1/4, and R 1/4. The following is the Trading and Profit and Loss Account of the firm for the six months ended March 31, 2013.

Trading and Profit and Loss Account

		₹	₹			₹	₹
To	Opening Stock:			By	Sales :		
	Cloth (A)	37,890			Cloth (A)	1,80,000	
	Ready-made Garments (B)	24,000			Ready-made Garments (B)	1,30,000	
	Tailoring Jobs (C)	20,000	81,890		Tailoring Jobs (C)	90,000	4,00,000
To	Purchases :			By	Discount received		800
	Cloth (A)	1,40,700		By	Closing Stock:		
	Ready-made Garments (B)	80,600			Cloth (A)	45,100	
	Tailoring Goods (C)	44,400	2,65,700		Ready-made Garments (B)	22,300	

To Salaries and Wages		48,000	Tailoring Jobs (C)		
To Advertising		2,400	[including ₹ 5,700 for goods		
To Rent		10,800	transferred from		
To Discount allowed		1,200	department (A)]	21,600	89,000
To Sundry Exp.		12,000			
To Depreciation on Furniture and Fittings		750			
To Net Profit		67,060			
		4,89,800			4,89,800

After consideration of the following, prepare (i) Departmental Trading and Profit and Loss Account and (ii) Profit and Loss Appropriation Account:

(i) Cloth of the value of ₹ 10,700 and other goods of the value of ₹ 600 were transferred at selling price by Departments A and B respectively to Department C.

(ii) Cloth and garments are sold in the show-room. Tailoring work is carried out in the workshop.

(iii) The details of salaries and wages were as follows:

(a) General Office 50%, show-room 25% and 25% for workshop, which is for tailoring.

(b) Allocate General Office Expenses, in the proportion of 3:2:1 among the Departments A, B, C.

(c) Distribute show-room expenses in the proportion of 1:2 between Departments A and B.

(iv) The workshop rent is ₹ 1,000 per month. The rent of the General Office and Show room is to be divided equally between Departments A and B.

(v) Depreciation charges are to be allocated equally amongst the three Departments.

(vi) All other expenses are to be allocated on the basis of turnover.

(vii) Discounts received are to be credited to the three Departments as follows: A: ₹ 400; B: ₹ 250; C: ₹ 150.

(viii) The opening stock of Department C does not include any goods transferred from Department A.

Solution

M/s D, B and R

Departmental Trading and Profit & Loss Account for the six months ended 31-3-2013

	A	B	C	Total		A	B	C	Total
To Opening Stock	37,890	24,000	20,000	81,890	By Sales	1,80,000	1,30,000	90,000	4,00,000
To Purchases	1,40,700	80,600	44,400	2,65,700	By Transfer	10,700	600	-	11,300

To	Transfer	–	-	11,300	11,300	By	Closing				
To	Wages	–	-	12,000	12,000		Stock	45,100	22,300	21,600	89,000
To	Gross profit c/d	57,210	48,300	23,900	1,29,410						
		2,35,800	1,52,900	1,11,600	5,00,300			2,35,800	1,52,900	1,11,600	5,00,300
To	Salaries & Wages:					By	Gross profit b/d	57,210	48,300	23,900	1,29,410
	General Office	12,000	8,000	4,000	24,000	By	Discount Received	400	250	150	800
	Showroom	4,000	8,000	–	12,000						
	Advertising	1,080	780	540	2,400						
To	Rent	2,400	2,400	6,000	10,800						
To	Discount Allowed	540	390	270	1,200						
To	Sundry Expenses	5,400	3,900	2,700	12,000						
To	Depreciation	250	250	250	750						
To	Net Profit c/d	31,940	24,830	10,290	67,060						
		57,610	48,550	24,050	1,30,210			57,610	48,550	24,050	1,30,210

Note: Gross profit of Department A is 30% of Sales price (including transfer to Department C).

There is some unrealised profit only on inter departmental stock. 30% of ₹ 5,700 is as stock reserve. This will be debited to Profit and Loss Appropriation Account.

Profit and Loss Appropriation Account

		₹	₹			₹
To	Stock Reserve (See Note)		1,710	By	Net Profit transfered from Profit & Loss A/c	67,060
To	D: 75% of Profit of Deptt. A	23,955				
	50% of Combined profits	7,527	31,482			
To	B : 75% of Profit of Deptt. B	18,623				
	25% of Combined profits	3,763	22,386			
To	R: 75% of Profit of Deptt. C	7,718				
	25% of Combined profits	3,764	11,482			
			67,060			67,060

Illustration 3

M/s Complex has 3 departments, A, B, C. The following information is provided:

	A	B	C
	₹	₹	₹
Opening Stock	3,000	4,000	6,000
Consumption of direct materials	8,000	12,000	–
Wages	5,000	10,000	–
Closing Stock	4,000	14,000	8,000
Sales	–	–	34,000

Stock of each department is valued at cost to the department concerned, Stocks of A department are transferred to B at a margin of 50% above departmental cost, Stocks of B department are transferred to C department at a margin of 10% above departmental cost. Other expenses were:

	₹
Salaries	2,000
Printing & Stationery	1,000
Rent	6,000
Interest paid	4,000
Depreciation	3,000

Allocate expenses in the ratio of departmental gross profit. Opening figures of reserves for unrealised profits on departmental stock were:

Department B ₹ 1,000

Department C ₹ 2,000

Prepare Departmental Trading and Profit & Loss Accounts for the year ending March 31, 2013 considering that closing stock of each department consists of only finished goods..

Solution

M/s Complex Departmental Trading and Profit & Loss Account for year ended 31-3-2013

		A	B	C	Total			A	B	C	Total
		₹	₹	₹	₹			₹	₹	₹	₹
To	Opening Stock	3,000	4,000	6,000	13,000	By	Internal transfer	18,000	33,000	-	51,000
To	Direct material					By	Sales	-	-	34,000	34,000
	consumption	8,000	12,000	-	20,000	By	Closing stock	4,000	14,000	8,000	26,000
To	Wages	5,000	10,000	-	15,000						
To	Internal transfer	-	18,000	33,000	51,000						

To	Gross Profit c/d	6,000	3,000	3,000	12,000						
		22,000	47,000	42,000	1,11,000			22,000	47,000	42,000	1,11,000
To	Salaries	1,000	500	500	2,000	By	Gross profit b/d	6,000	3,000	3,000	12,000
To	Printing & Stationery	500	250	250	1,000	By	Net Loss c/d	2,000	1,000	1,000	4,000
To	Rent	3,000	1,500	1,500	6,000						
To	Depreciation	1,500	750	750	3,000						
To	Interest paid	2,000	1,000	1,000	4,000						
		8,000	4,000	4,000	16,000			8,000	4,000	4,000	16,000
To	Net Loss b/d				4,000	By	Reserve for unrealised profit (on opening stock)				3,000
To	Reserve for unrealised profit on closing stock				3,918	By	Balance transferred to P & L A/c				4,918
					7,918						7,918

Working Notes:

Calculation of Unrealised Profit on Closing Stock:

Dept. B: Closing Stock ₹ 14,000

Cost element transferred from Deptt. A ₹ 14,000 x $\frac{18,000}{40,000}$ = ₹ 6,300

Profit added by Deptt. A ₹ 6,300 x $\frac{50}{150}$ = ₹ 2,100

Clarification: Cost increased during the current period by Deptt. B are Direct Material ₹ 12,000, Wages ₹ 10,000 and Transfer received from Deptt. A ₹ 18,000; Total ₹ 40,000.

So, cost element of Deptt. A ₹ 18,000 in closing stock is $\frac{₹\ 18,000}{₹\ 40,000}$

(FIFO formula for stock issue is assumed)

Deptt. C: Closing Stock ₹ 8,000.

Profit added by Deptt. B: ₹ 8,000 $\times \frac{10}{110}$ = ₹ 727

Cost element from Deptt. A:

$$(₹\ 8,000 - ₹\ 727) \times \frac{₹\ 18,000}{₹\ 40,000} = ₹\ 3,273$$

Profit added by Deptt. A: ₹ 3,273 $\times \frac{50}{150}$ = ₹ 1,091

₹ 1,818

Total Unrealised Profit: ₹ 2,100 + ₹ 1,818 = ₹ 3,918

Illustration 4

M/s X has two departments, A and B. From the following particulars prepare the consolidated Trading Account and Departmental Trading Account for the year ending 31st December, 2012:

	A	*B*
	₹	₹
Opening Stock (at cost)	*20,000*	*12,000*
Purchases	*92,000*	*68,000*
Sales	*1,40,000*	*1,12,000*
Wages	*12,000*	*8,000*
Carriage	*2,000*	*2,000*
Closing Stock:		
(i) Purchased goods	*4,500*	*6,000*
(ii) Finished goods	*24,000*	*14,000*
Purchased goods transferred:		
by B to A	*10,000*	
by A to B		*8,000*
Finished goods transferred:		
by A to B	*35,000*	
by B to A		*40,000*
Return of finished goods:		
by A to B	*10,000*	
by B to A		*7,000*

You are informed that purchased goods have been transferred mutually at their respective departmental purchase cost and finished goods at departmental market price and that 20% of the finished stock (closing) at each department represented finished goods received from the other department.

Solution

M/s X

Departmental Trading A/c for the year ending 31st December, 2012

	Deptt. A. ₹	Deptt. B ₹		Deptt. A ₹	Deptt. B ₹
To Stock	20,000	12,000	By Sales	1,40,000	1,12,000
To Purchases	92,000	68,000	By Purchased Goods transferred	8,000	10,000

To Wages	12,000	8,000	By	Finished goods transferred	35,000	40,000
To Carriage	2,000	2,000		Return of finished Goods	10,000	7,000
To Purchased Goods			By	Closing Stock:		
To transferred	10,000	8,000		Purchased Goods	4,500	6,000
To F.G. transferred	40,000	35,000		Finished Goods	24,000	14,000
To Ret. of finished Goods	7,000	10,000				
To Gross profit c/d	38,500	46,000				
To	2,21,500	1,89,000			2,21,500	1,89,000

Consolidated Trading Account for the year ending 31st December, 2012

	₹		₹
To Opening Stock	32,000	By Sales	2,52,000
To Purchases	1,60,000	By Closing Stock:	
To Wages	20,000	Purchased Goods	10,500
To Carriage	4,000	Finished Goods	38,000
To Stock Reserve	2,196		
To Gross Profit c/d	82,304		
	3,00,500		3,00,500

Working note:

	Deptt. A	Deptt. B
Closing Stock out of transfer	4,800	2,800
Sale	1,40,000	1,12,000
Add : Transfer	35,000	40,000
	1,75,000	1,52,000
Less: Returns	(7,000)	(10,000)
Net Sales plus Transfer	1,68,000	1,42,000

Rate of Gross profit $\frac{38{,}500}{1{,}68{,}000} \times 100 = 22.916\%$ $\qquad \frac{46{,}000}{1{,}42{,}000} \times 100 = 32.394\%$

Unrealised Profit $\quad 4{,}800 \times 32.394\% = 1{,}555 \qquad 2{,}800 \times 22.916\% = 641$

Illustration 5

M/s Alpha , has a factory with two manufacturing departments 'X' and 'Y'. Part of the output of department X is transferred to department Y for further processing and the balance is directly *transferred to selling department. The entire production of department Y is directly transferred to the selling department. Inter-departmental stock transfers are made as follows:*

X department to Y department at 33-1/3% over departmental cost.

X department to selling department at 50% over departmental cost.

Y department to selling department at 25% over departmental cost.

The following information is given for the year ending 31st March,2013.

	Department X		Department Y		Selling Department	
	Units	₹	Units	₹	Units	₹
Opening stock						
Finished Goods	60	60,000	20	40,000	50	1,28,000
Raw materials	–	–	–	–	–	–
Raw material consumed	–	1,82,000	–	20,000	–	–
Labour charges	–	70,000	–	32,000	–	–
Sales	–	–	–	–	120	4,80,000
Closing stock						
Finished Goods	40	–	50	–	60	–

Out of the total transfer by X department 30 units were transferred to selling department, while the remaining to department Y. Per unit material and labour consumption of X department on production to be transferred directly to the selling department is 300 per cent of the labour and material consumption on units transferred to Y department. General Administration expenses ₹1,80,000.

Prepare Departmental Profit and Loss Account and General Profit and Loss Account.

Solution

Departmental Profit and Loss Account for the year ended 31-3-2013

	X Deptt.		Y Deptt.		Selling Deptt.			X Deptt.		Y Deptt.		Selling Deptt	
	Qty	Amount ₹	Qty	Amount ₹	Qty	Amount ₹		Qty	Amount ₹	Qty	Amount ₹	Qty	Amount ₹
To Opening Stock	60	60,000	20	40,000	50	1,28,000	By Stock transfer	160	3,70,000	100	2,50,000	–	–
To Raw Material							By Sales	–	–	–	–	120	4,80,000
consumption &	140	1,82,000	–	20,000	–	–	By Closing						
Units produced						–	Stock	40	48,000	50	1,00,000	60	1,80,000
To Labour Charges		70,000		32,000									
To Stock Transfered													

from X Deptt.	-	-	130	2,08,000	30	1,62,000							
To Stock transfered													
from Y Deptt.					100	2,50,000							
To Departmental Profit transfered to General P & L A/c	–	1,06,000	–	50,000	–	1,20,000							
	200	4,18,000	150	3,50,000	180	6,60,000		200	4,18,000	150	3,50,000	180	6,60,000

General Profit and Loss Account

		₹			₹
To	General Expenses	1,80,000	By	Profit transferred from	
To	Stock Reserve for			X Deptt.	1,06,000
	Closing Stock:			Y Deptt.	50,000
	on Deptt. Y	12,000		Selling Deptt.	1,20,000
	on Selling Deptt.	18,175			
To	Net Profit	65,825			
		2,76,000			2,76,000

Working Notes:

(1) Calculation of units produced by Department X

	Selling Deptt. Units	*Deptt. Y Units*	*Deptt. X Units*
Sales	120	–	–
Transfer to Selling Deptt.	–	100	30
Transfer to X Deptt.	–	–	–
Transfer to Y Deptt.	–	–	130
Closing Stock	60	50	40
	180	150	200
Opening Stock	50	20	60
Transfer from X Deptt.	30	130	–
Transfer from Y Deptt. (balancing figure)	100	–	–
Production during year (balancing figure)			140
	180	150	200

(2) Cost of Production and Transfer price

Department: X	*Units*	₹
Cost of output including opening stock		3,12,000
Transfer to selling department		
30 Units : Equivalent units	90	
Transfer to Y Department	130	
Closing Stock	40	
	260	

Cost of goods transferred to selling Department = ₹$\frac{3,12,000}{260}$ × 90 = ₹ 1,08,000

Transfer Price i.e. Cost plus 50%: (₹ 1,08,000 + 50% of ₹ 1,08,000)	1,62,000

Cost of goods transferred to Department Y: ₹$\frac{3,12,000}{260} \times 130$ = ₹ 1,56,000

Transfer price: Cost plus 33-1/3% i.e.(₹ 1,56,000 + 33-1/3% of ₹ 1,56,000)=	2,08,000
Total Transfer	3,70,000

Department Y		₹
Total cost of output		3,00,000
Total output	150 units	
Cost per unit		2,000
Cost of transfer to selling Deptt.	100 units	2,00,000
Transfer Price: Cost plus 25%		2,50,000

(3) Calculation of Closing Stock

			₹
Deptt. X $\frac{₹\ 3,12,000}{260} \times 40$			48,000
Deptt. Y $\frac{₹\ 3,00,000}{150} \times 50$			1,00,000
Selling Deptt (Closing Stock 60 units)	Units	₹	
Opening Stock	50	1,28,000	
Transfer from Deptt. X	30	1,62,000	
Transfer from Deptt. Y	100	2,50,000	
	180	5,40,000	
Average Cost		3,000	1,80,000

(4) Calculation of unrealised profit on stock

Deptt. Y: Increase in Stock (₹ 1,00,000 — ₹ 40,000) = ₹ 60,000

	₹
Cost element of Deptt. X	2,08,000
Cost of Deptt. Y	52,000
Total Cost excluding Value of the Opening Stock:	2,60,000

Proportion: $\frac{₹\ 2,08,000}{₹\ 2,60,000}$

Unrealised Profit: $₹\ 60,000 \times \frac{2,08,000}{2,60,000} \times \frac{1}{4} = ₹\ 12,000$

Selling Deptt.: Increase in Stock (₹ 1,80,000 — ₹ 1,28,000) = ₹ 52,000

Total transfer from two departments = ₹ 4,12,000

Proportion of Deptt. X $\frac{₹ 1,62,000}{₹ 4,12,000}$

Proportion of Deptt. Y $\frac{2,50,000}{4,12,000}$

Output of Deptt. X in increase in Stock $₹\ 52,000 \times \frac{1,62,000}{4,12,000} = ₹\ 20,447$

Output of Deptt. Y in increase in Stock $₹\ 52,000 \times \frac{2,50,000}{4,12,000} = ₹\ 31,553$

Profit loaded by Deptt. Y $₹\ 31,553 \times \frac{1}{5} =$ ₹ 6,311

Profit loaded by Deptt. X

For transfer from Deptt. Y (₹ 31,553 - ₹ 6,311) $\times \frac{2,08,000}{2,60,000} \times \frac{1}{4} =$ ₹ 5,048

For Direct Transfer $₹\ 20,447 \times \frac{1}{3}$ ₹ 6,816

₹ 18,175

Illustration 6

Gram Udyog, a retail store, has two departments, 'Khadi and Silks' for each of which stock account and memorandum 'mark up' accounts are kept. All the goods supplied to each department are debited to the stock account at cost plus a 'mark up', which together make-up the selling-price of the goods and in the account of the sale proceeds of the goods are credited. The amount of 'mark-up' is credited to the Departmental Mark up Account. If the selling price of any goods is reduced below its normal selling price, the reduction 'marked down' is adjusted both in the Stock Account and the Departmental 'Mark up' Account. The rate *of 'Mark up' for Khadi Department is 33-1/3% of the cost and for Silks Department it is 50% of the cost.*

The following figures have been taken from the books for the year ended December 31,2012:

	Khadi Deptt.	*Silks Deptt.*
	₹	*₹*
Stock as on January 1st at cost	*10,500*	*18,600*
Purchases	*75,900*	*93,400*
Sales	*95,600*	*1,25,000*

(1) The stock of Khadi on January 1, 2012 included goods the selling price of which had been marked down by ₹ 1,260. These goods were sold during the year at the reduced prices.

(2) Certain stock of the value of ₹ 6,900 purchased for the Khadi Department were later in the year transferred to the Silks department and sold for ₹ 10,350. As a result though cost of the goods is included in the Khadi Department the sale proceeds have been credited to the Silks Department.

(3) During the year 2012 to promote sales the goods were marked down as follows :

	Cost	*Marked down*
	₹	*₹*
Khadi	*5,600*	*360*
Silk	*10,000*	*2,000*

All the goods marked down, were sold except Silks of the value of ₹ 5,000 marked down by ₹ 1,000.

(4) At the time of stock-taking on December 31, 2012 it was discovered that Khadi cloth of the cost of ₹ 390 was missing and it was decided that the amount be written off.

You are required to prepare for both the departments for the year 2012.

(a) The Memorandum Stock Account; and

(b) The Memorandum Mark up Account.

Solution

Silk Stock Account

2012		*₹*	*2012*	*₹*
To Balance b/d			By Sales A/c	1,25,000
To Cost	18,600		By Mark-up A/c	2,000
Mark-up	9,300	27,900	By Balance c/d	51,350
To Purchases	93,400			
Mark-up	46,700	1,40,100		

To Khadi A/c	6,900			
Mark-up	3,450	10,350		
		1,78,350		1,78,350

Silk Mark-up Account

2012	₹	2012	₹
To Stock A/c	2,000	By Balance b/d	9,300
To Profit & Loss A/c	41,000	By Stock A/c	46,700
To Balance c/d [(1/3 of 52,350) – 1,000]	16,450	By Stock A/c	3,450
	59,450		59,450

Working Notes:

Verification of Profit	₹
Sales	1,25,000
Add : Mark down in goods sold	1,000
	1,26,000
Gross Profit 1/3	42,000
Less : Mark down	(1,000)
Gross profit as per books	41,000

Khadi Stock Account

2012			₹	₹	2012			₹	₹
	To	Balance b/d				By	Sales		95,600
		(10,500+2,240)		12,740			Silk Deptt.	6,900	
	To	Purchases	75,900				Mark-up A/c	2,300	9,200
		Markup	25,300	1,01,200		By	Loss of stock A/c	390	
							Mark-up A/c	130	520
						By	Mark-up A/c		360
						By	Balance c/d		8,260
				1,13,940					1,13,940

Khadi Mark-up Account

2012			₹	2012			₹
	To	Stock A/c (transfer)	2,300		By	Balance b/d	
	To	Stock A/c (re-sale)	130			(3,500 – 1,260)	2,240
	To	Stock A/c (mark down)	360		By	Stock A/c	25,300
	To	Profit & Loss A/c	22,685				
	To	Balance (1/4 of ₹ 8,260)	2,065				
			27,540				27,540

Working Note:

Verification of Profit	₹
Sales as per books	95,600
Add : Mark-down (1,260+360)	1,620
	97,220
Gross Profit on fixed selling price @ 25% on ₹ 97,220	24,305
Less : Mark down	(1,620)
	22,685

Illustration 7

Department P sells goods to Department S at a profit of 25% on cost and to Department Q at a profit of 15% on cost. Department S sells goods to P and Q at a profit of 20% and 30% on sales respectively. Department Q sells goods to P and S at 20% and 10% profit on cost respectively.

Departmental Managers are entitled to 10% commission on net profit subject to unrealized profit on departmental sales being eliminated. Departmental profits after charging Manager's commission, but before adjustment of unrealized profits are as below:

	₹
Department P	*90,000*
Department S	*60,000*
Department Q	*45,000*

Stock lying at different Departments at the end of the year are as below:

			Figures in ₹
	DEPARTMENTS		
	P	*S*	*Q*
Transfer from P	-	*18,000*	*14,000*
Transfer from S	*48,000*	-	*38,000*
Transfer from Q	*12,000*	*8,000*	-

Find out correct Departmental Profits after charging Managers' Commission.

Solution

Calculation of correct Departmental Profits

	Department P (₹)	*Department S (₹)*	*Department Q (₹)*
Profit after charging Manager's Commission	90,000	60,000	45,000

Add: Manager's Commission (1/9)	10,000	6,667	5,000
	1,00,000	66,667	50,000
Less: Unrealised profit on Stock (WN)	(5,426)	(21,000)	(2,727)
Profit Before Manager's Commission	94,574	45,667	47,273
Less: Manager's Commission 10%	(9,457)	(4,567)	(4,727)
Correct Profit after Manager's Commission	85,117	41,100	42,546

Working Notes:

	Department P (₹)	*Department S* (₹)	*Department Q* (₹)	*Total* (₹)
Unrealized Profit of:				
Department P	-	25/125X18,000 =3,600	15/115X14,000 =1,826	5,426
Department S	20/100X48,000 =9,600	-	30/100X38,000 =11,400	21,000
Department Q	20/120X12,000 =2,000	10/110X8,000 =727		2,727

Summary

- Aspects of Departmental Accounting
  (i) Computation of unrealized profit if inter-department transfers form part of closing inventory.
  (ii) Preparation of departmental trading and profit and loss account.
  (iii) Monitoring inventory movements with help of memorandum mark-up account.
- Methods of maintaining departmental accounts
  There are two methods of keeping departmental accounts:
  (i) When accounts of all departments are kept at in one book only
  (ii) When separate set of books are kept for each department.
- Departments are classified into two types: (i) Dependent departments and (ii) Independent departments.
- Basis of allocation of departmental expenses:

S.No.	*Expenses*	*Basis*
1.	Rent, rates and taxes, repairs and	Floor area occupied by each department (if

	maintenance, insurance of building	given) other wise on time basis
2.	Lighting and Heating expenses	Consumption of energy by each department
3.	Selling expenses,	Sales of each department
4.	Carriage inward/ Discount received	Purchases of each department
5.	Wages/Salaries	Time devoted to each department
6.	Maintenance of capital assets	Value of assets of each department otherwise on time basis
7.	Administrative expenses	Time basis or equally among all departments

- There are certain expenses and income, most being of financial nature, which cannot be apportioned on a suitable basis; therefore they are recognised in the combined Profit and Loss Account for example- interest on loan, profit/loss on sale of investment etc.
- Goods and services may be charged by one department to another usually on any of the three basis: (i)Cost, (ii) Ruling market price,(iii) Cost plus percentage of profit.
- When profit is added in the inter-departmental transfers the loading included in the unsold stock at the end of the year is to be excluded before final accounts are prepared so as to eliminate any anticipatory profit included therein. This is done by creating an appropriate stock reserve by debiting the combined Profit and Loss Account.

8

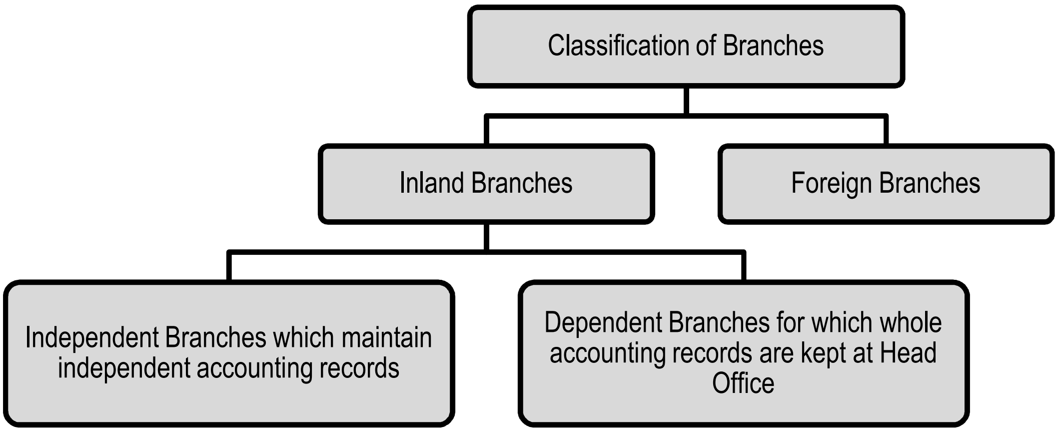
Accounting for Branches Including Foreign Branches

Learning Objectives

- After studying this chapter, you will be able to: Understand concept of branches and their classification from accounting point of view.
- Distinguish between the accounting treatment of dependent branches and independent branches.
- Learn various methods of charging goods to branches.
- Solve the problems, when goods are sent to branch at wholesale price.
- Prepare the reconciliation statement of branch and head office transactions after finding the reasons for their disagreement.
- Incorporate branch balances in the head office books.
- Prepare branch accounts even on the basis of incomplete information.
- Differentiate between integral and non-integral foreign branches.
- Learn the techniques of foreign currency translation.

1. Introduction

A branch can be described as any establishment carrying on either the same or substantially the same activity as that carried on by head office of the company. It must also be noted that the concept of a branch means existence of a head office for there can be no branch without a head office - the principal place of business. From the accounting point of view, branches may be classified as follows:



2. Distinction Between Branch Accounts And Departmental Accounts

Basis of distinction	Branch Accounts	Departmental Accounts
1. Maintenance of accounts	Branch accounts may be maintained either at branch or at head office.	Departmental accounts are maintained at one place only.
2. Allocation of common expenses	No allocation problem arises since the expenses in respect of each branch can be identified.	Common expenses are distributed among the departments concerned on some equitable basis considered suitable in the case.
3. Reconciliation	Reconciliation of head office and branch accounts is necessary in case of independent branches at the end of the accounting year.	No such problem arises.
4. Conversion of foreign currency figures	At the time of finalization of accounts, conversion of figures of foreign branch is necessary.	No such problem arises in departmental accounts.

3. Dependent Branches

When the business policies and the administration of a branch are wholly controlled by the head office and its accounts also are maintained by it the branch is described as Dependant branch. Branch accounts, in such a case, are maintained at the head office out of reports and returns received from the branch. Some of the significant types of branches that are operated in this manner are described below:

(a) A branch set up merely for booking orders that are executed by the head office. Such a branch only transmits orders to the head office;

(b) A branch established at a commercial centre for the sale of goods (wholesale) supplied by the head office, and under its direction all collections are made by the H.O.; and

(c) A branch for the retail sale of goods, supplied by the head office.

Accounting in the case of first two types is simple. Only a record of expenses incurred at the branch has to be maintained.

But however a retail branch is essentially a sale agency that principally sells goods supplied by the head office for cash and, if so authorised, also on credit to approved customers. Generally, cash collected is deposited into a local bank to the credit of the head office and the head office issues cheques thereon for meeting the expenses of the branch. In addition, the Branch Manager is provided with a 'float' for petty expenses which is replenished from time to time on an imprest basis. If, however, the branch also sells certain lines of goods, directly purchased by it, the branch retains a part of the sale proceeds to pay for the goods so purchased.

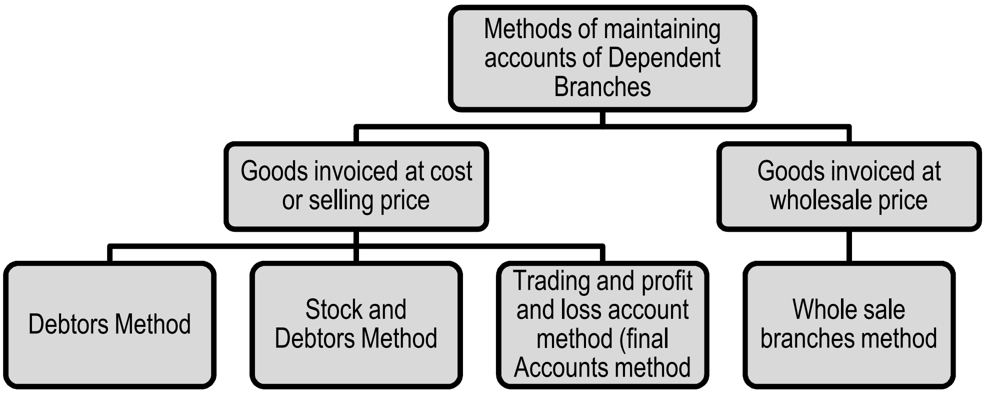
4. Methods of Charging Goods to Branches

Goods may be invoiced to branches (1) at cost; or (2) at selling price; or (3) in case of retail branches, at wholesale price.

Selling price method is adopted where the goods would be sold at a fixed price by the branch. It is suitable for dealers in tea, petrol, vanaspati ghee, etc. In this way, greater control can be exercised over the working of a branch in as much as that the branch balance in the head office books would always be composed of the value of unsold stock at the branch and remittances or goods in transit. The arbitrary price method is usually adopted if the selling price is not known or when it is not considered desirable to disclose to the branch manager the profit made by the branch.

5. Accounting for Dependent Branches

Dependent branch does not maintain a complete record of its transactions. The Head office may maintain accounts of dependent branches in any of the following methods:



5.1 When goods are invoiced at cost: If goods are invoiced to the branch at cost, the trading results of branch can be ascertained by following any of the three methods: (i) **Debtors Method,** (ii)**Stock and Debtors method, (iii) Trading and Profit and Loss Account (Final Accounts) Method**.

For finding out the trading results of branch, it is assumed that the branch is an entity separate from the head office. On the basis, a Branch Account is stated in the head office books to which the price of goods or services provided or expenses paid out are debited and correspondingly, the value of benefits and cash received from the branch are credited.

Debtors method: This method of accounting is suitable for small sized branches. Under this method, separate branch account is maintained for each branch to compute profit or loss made by each branch. The opening balance of stock, debtors (if any), petty cash (if any), are debited to the Branch Account; the cost of goods sent to branch as well as expenses of the branch paid by the head office, *e.g.,* salaries, rent, insurance, etc., are also debited to it. Conversely, amounts remitted by the branch and the cost of goods returned by the branch are credited. At the end of the year, the value of unsold stock, the total of customers' balances outstanding and that of petty cash are brought into the branch account on the credit side and then the branch account will reveal profit or loss; Debit 'balance' will be the loss suffered by the working of the branch and *vice versa*. If the branch is allowed to make small purchases of goods locally as well as to incur expenses out of its cash receipts, it will be necessary for the branch to supply to the head office a copy of the Cash Account, showing details of cash collections and disbursements. To illustrate the various entries which are made in the Branch Account, the proforma of a Branch Account is shown below:

Proforma Branch Account

To Balance b/d Stock Debtors		By Bank A/c (Cash remitted) By Return to H.O. By Balance c/d	

Petty Cash		Cash	
To Goods sent to Branch		Debtors	
To Bank A/c		Petty Cash	
Salaries		Fixed Assets	
Rent		Prepaid Expenses	
Sundry Expenses		By Profit and Loss A/c—Loss	
To Profit & Loss A/c—Profit		(if debit side is larger)	
(if credit side is larger)			

Note:

1. Having credited the Branch Account by the actual cash received from debtors, it would be wrong to debit the Branch Account, in respect of discount or allowances to debtors.
2. The accuracy of the trading results as disclosed by the Branch Account, so maintained, if considered necessary, can be proved by preparing a Memorandum Branch Trading and Profit & Loss Account, in the usual way, from the balances of various items of income and expenses contained in the Branch Account.

Illustration 1

Fanna Cloth Mills opened a branch at Mumbai on 1st April, 2011. The goods were invoiced to the branch at selling price which was 125% of the cost to the head office.

The following are the particulars of the transactions relating to branch during the year ended 31st March, 2012:

	₹	₹
Goods sent to branch at cost to head office		*42,12,600*
Sales:		
Cash	*18,76,050*	
Credit	*26,61,450*	*45,37,500*
Cash collected from debtors		*23,55,000*
Discount allowed to debtors		*23,550*
Returns from debtors		*15,000*
Spoiled cloth in bales written off at invoice price		*7,500*
Cheques sent to branch for:		
Rent	*1,08,000*	
Salaries	*2,70,000*	
Other Expenses	*52,500*	*4,30,500*

Prepare Branch Account based on invoice price under Debtors method for ascertaining profit for the year ended 31st March, 2012.

Solution

Branch Account

		₹	₹			₹	₹
To	Goods sent to Branch Account		52,65,750	By	Bank-		
To	Bank -				Sales	18,76,050	
	Rent Salaries	1,08,000 2,70,000			Collection from debtors	23,55,000	42,31,050
	Other expenses	52,500	4,30,500	By	Goods sent to Branch Account (Loading)		10,53,150
To	Branch Stock Reserve		1,47,150		(52,65,750x25/125)		
	(7,35,750x25/125)			By	Abnormal Loss		
To	H.O. Profit and Loss Account				-Cost of spoiled cloth (7,500x100/125)		6,000
	-Transfer of profit		4,50,450	By	Balance c/d		
					Branch Stock	7,35,750	
					Branch Debtors	2,67,900	10,03,650
			62,93,850				62,93,850

Working Notes:

1. Memorandum Branch Stock Account

		₹	₹			₹
To	Goods sent to Brach:	.		By	Cash - Sales	18,76,050
	Cost	42,12,600		By	Credit Sales	26,61,450
	Add: Loading @ 25%	10,53,150	52,65,750	By	Abnormal Loss - Spoiled cloth	7,500
To	Returns from Debtors		15,000	By	Balance c/d (Balancing figure)	7,35,750
			52,80,750			52,80,750

2. Memorandum Branch Debtors Account

		₹			₹
To	Credit Sales	26,61,450	By	Cash collected	23,55,000
			By	Discount allowed	23,550

		By	Returns	15,000
		By	Balance c/d (Balancing figure)	2,67,900
	26,61,450			26,61,450

Illustration 2

Buckingham Bros, Bombay have a branch at Nagpur. They send goods at cost to their branch at Nagpur. However, direct purchases are also made by the branch for which payments are made at head office. All the daily collections are transferred from the branch to the head office.

From the following, prepare Nagpur branch account in the books of head office by Debtors method:

	₹		₹
Opening balance (1-1-2012)		*Bad Debts*	*1,000*
Imprest Cash	*2,000*		
Sundry Debtors	*25,000*	*Discount to Customers*	*2,000*
Stock: Transferred from H.O.	*24,000*	*Remittances to H.O.*	
Direct Purchases	*16,000*	*(recd. by H.O.)*	*1,65,000*
Cash Sales	*45,000*	*remittances to H.O.*	
Credit Sales	*1,30,000*	*(not recd. by H.O. so far)*	*5,000*
Direct Purchases	*45,000*	*Branch Exp. directly paid by H.O.*	*30,000*
Returns from Customers	*3,000*	*Closing Balance (31-12-2012)*	
Goods sent to branch from H.O.	*60,000*	*Stock: Direct Purchase*	*10,000*
Transfer from H.O. for Petty		*Transfer from H.O.*	*15,000*
Cash Exp.	*4,000*	*Debtors*	*?*
		Imprest Cash	*?*

Solution

In the Books of Buckingham Bros, Bombay
Nagpur Branch Account

		₹				₹
To	Opening Branch Assets		By	Bank – Remittances received from branch		
	Stock (24,000+16,000)	40,000		Cash Sales	45,000	
	Debtors	25,000		Cash from Debtors	1,20,000	
	Imprest Cash	2,000		Cash from Debtors in transit	5,000	1,70,000
To	Goods sent to Branch A/c	60,000	By	Stock:		
To	Creditors (Direct Purchases)	45,000		Transfer from H.O.		15,000
To	Bank (Sundry exp.)	30,000		Direct Purchase		10,000

To	Bank (Petty cash exp.)	4,000	By	Sundry Debtors (W.N. 2)		24,000
To	Net Profit transferred to		By	Imprest Cash (W.N. 3)		2,000
To	General Profit & Loss A/c	15,000				
		2,21,000				2,21,000

Working Notes:

(1) *Collections from debtors:*

	₹
Total remittances (₹ 1,65,000 + ₹ 5,000)	1,70,000
Less: Cash sales	(45,000)
	1,25,000

(2) *Calculation of Sundry Debtors closing Balance:*

	₹
Opening Balance	25,000
Add: Credit Sales	1,30,000
	1,55,000
Less: Returns, Discount, Bad debts & collections (3,000 + 2,000 + 1,000 + 1,25,000)	(1,31,000)
Closing balance	24,000

(3) Calculation of closing balance of Imprest Cash

	₹
Opening Balance	2,000
Add: Transfer from H.O.	4,000
	6,000
Less: Expenses*	(4,000)
Closing balance	2,000

*It is assumed that petty cash expenses of the branch for the year were ₹ 4,000.

Illustration 3

LMN is having branch at Mumbai. Goods are invoiced to the branch at 25% profit on sale. Branch has been instructed to send all cash daily to head office. All expenses are paid by head office except petty expenses, which are met by the Branch. From the following particulars, prepare branch account in the books of head office:

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
Stock as on 1st April, 2013 (Invoice price)	*40,000*	*Discount allowed to debtors*	*300*

Sundry Debtors as on 1st April, 2013	*25,000*	*Expenses paid by head office:*	
		Salary	*4,000*
Cash in hand as on 1st April, 2013	*1,000*	*Staff Welfare*	*750*
Office furniture as on 1st April, 2013	*4,000*	*Telephone Expenses*	*1,200*
Goods invoiced from head office (invoice price)	*1,80,000*	*Other Misc. Expenses paid by branch*	*700*
Goods return to head office	*6,000*	*Stock as on 31st March, 2014 (at invoice price)*	*35,000*
Goods return by debtors	*1,250*	*Depreciation to be provided*	*10% p.a.*
Cash received from Debtors	*65,000*	*on branch furniture*	
Cash sales	*1,20,000*		
Credit sales	*70,000*		

Answer

In the books of Head Office - LMN

Mumbai Branch Account (At invoice price)

Particulars		*Amount (₹)*	*Particulars*		*Amount (₹)*
To Balance b/d:			By Stock Reserve (opening)		10,000
Stock		40,000	By Remittances		
Debtors		25,000	Cash Sales	1,20,000	
Cash in hand		1,000	Cash from Debtors	65,000	1,85,000
Furniture		4,000	By Goods sent to Branch (loading)		45,000
To Goods sent to branch		1,80,000			
To Goods returned by branch (loading)		1,500	By Goods returned by branch (Returns to HO)		6,000
To Bank (Expenses paid by Head Office):			By Balance c/d:		
			Stock		35,000
Salary	4,000		Debtors		28,450
Staff Welfare	750		Cash (₹1,000-₹700)		300
Telephone	1,200	5,950	Furniture (₹4,000-₹400)		3,600
To Stock Reserve (closing)		8,750			
To Profit Transferred to General Profit & Loss A/c		47,150			
		3,13,350			3,13,350

Working Note:

Debtors Account

Particulars	*Amount (₹)*	*Particulars*	*Amount (₹)*
To Balance b/d	25,000	By Cash A/c	65,000
To Sales A/c (Credit)	70,000	By Sales Return	1,250
		By Discount allowed	300
		By Balance c/d	28,450
	95,000		95,000

Note: It is assumed that goods returned by branch are at invoice price.

Stock and Debtors method

If it is desired to exercise a more detailed control over the working of a branch, the accounts of the branch are maintained under what is described as the Stock and Debtors Method. According to this method, the following accounts are maintained by the Head Office:

Account	**Purpose**
1. Branch Stock Account (or Branch Trading Account)	Ascertainment of shortage or surplus
2. Branch Profit and Loss Account	Calculation of net profit or loss
3. Branch Debtors Account	Ascertainment of closing balance of debtors
4. Branch Expenses Account	Ascertainment of total expenses incurred
5. Goods sent to Branch Account	Ascertainment of cost of goods sent to branch

If the branch is also allowed to purchase goods locally and to incur expenses out of its cash collections, it would be necessary to maintain (*i*) a Branch Cash Account, and (*ii*) an independent record of branch assets.

The manner in which entries are recorded in the above method is shown below:

	Transaction	**Account debited**	**Account credited**
(*a*)	Cost of goods sent to the Branch	Branch Stock A/c	Goods sent to Branch A/c
(*b*)	Remittances for expenses	Branch Cash A/c	(H.O.) Cash A/c
(*c*)	Any assets (*e.g.* furniture) provided by H.O.	Br Asset (Furniture) A/c	(*i*) (H.O.) Cash A/c or (*ii*) Creditors A/c (*iii*) (H.O.) Furniture A/c
(*d*)	Cost of goods returned by	Goods sent to Branch A/c	Branch Stock A/c

	the branch		
(*e*)	Cash Sales at the Branch	Branch Cash A/c	Branch Stock A/c
(*f*)	Credit Sales at the Branch	Branch Debtors A/c	Branch Stock A/c
(*g*)	Return of goods by debtors to the Branch	Branch Stock A/c	Branch Debtors A/c
(*h*)	Cash paid by debtors	Branch Cash A/c	Branch Debtors A/c
(*i*)	Discount & allowance to debtors, bad debts	Branch Expenses A/c	Branch Debtors A/c
(*j*)	Remittances to H.O.	(H.O.) Cash A/c	Branch Cash A/c
(*k*)	Expenses met by H.O.	Branch Expenses A/c	(H.O.) Cash A/c

(*l*) *Closing Stock*: Credit the Branch Stock Account with the value of closing stock at cost. It will be carried down as opening balance (debit) for the next accounting period. The Balance of the Branch Stock Account, (after adjustment therein the value of closing stock), if in credit, will represent the gross profit on sales and vice versa.

Other Steps

(*m*) Transfer Balance of Branch Stock Account to the Branch Profit and Loss Account.

(*n*) Transfer Balance of Branch Expenses Account to the debit of Branch Profit & Loss Account.

(o) The balance in the Branch P&L A/c will be transferred to the (H.O.) Profit & Loss Account.

The credit balance in the Goods sent to Branch Account is afterwards transferred to the Head Office Purchase Account or Trading Account (in case of manufacturing concerns), it being the value of goods transferred to the Branch.

Branch Trading and Profit and Loss Account (Final Accounts Method)

In this method, Trading and Profit and Loss accounts are prepared considering each branch as a separate entity. The main advantage of this method is that, it is easy to prepare and understand. It also gives complete information of all transactions which are ignored in the other methods. It should be noted that Branch Trading and Profit and Loss account is merely a memorandum account and therefore, the entries made there in do not have double entry effect.

Illustration 4

From the information given in the illustration 2, prepare Nagpur Branch Trading and Profit and Loss Account in the books of head office.

Solution

Buckingham Bros. Bombay
Nagpur Branch-Trading and Profit and Loss Account
for the year ending 31st December, 2012

		₹			₹	₹
To	Opening Stock	40,000	By	Sales		
To	Goods transferred from			Cash	45,000	
	Head Office	60,000		Credit sales	1,30,000	
To	Purchases	45,000			1,75,000	
To	Gross Profit c/d	52,000		*Less:* Returns	(3,000)	1,72,000
			By	Closing Stock		25,000
		1,97,000				1,97,000
To	Expenses	30,000	By	Gross Profit b/d		52,000
To	Discounts	2,000				
To	Bad Debts	1,000				
To	Petty Cash Expenses	4,000				
To	Net Profit transferred to					
	General P&L A/c	15,000				
		52,000				52,000

The students may note that Gross Profit and Net Profit earned by the branch are ascertainable in this method and also evaluating the performance of the branch is very much easier in this method than in the 'Debtors method'.

Solving Illustration by all three methods: Given below is a simple problem, the solution whereto has been prepared in all the three methods so as to show the distinguishing features of these methods.

Illustration 5

The Bombay Traders invoiced goods to its Delhi branch at cost. Head Office paid all the branch expenses from its bank account, except petty cash expenses which were met by the Branch. All the cash collected by the branch was banked on the same day to the credit of the Head Office. The following is a summary of the transactions entered into at the branch during the year ended December 31, 2012.

	₹		₹
Balances as on 1.1.2012:			
Stock	*7,000*	*Bad Debts*	*600*
Debtors	*12,600*	*Goods returned by customers*	*500*
Petty Cash,	*200*	*Salaries & Wages*	*6,200*
Goods sent from H.O.	*26,000*	*Rent & Rates*	*1,200*
Goods returned to H.O.	*1,000*	*Sundry Expenses*	*800*

Cash Sales	*17,500*	*Cash received from Sundry*	
Credit Sales	*28,400*	*Debtors*	*28,500*
Allowances to customers	*200*	*Balances as on 31.12.2012:*	
Discount to customers	*1,400*	*Stock*	*6,500*
		Debtors	*9,800*
		Petty Cash	*100*

Prepare: *(a) Branch Account (Debtors Method), (b) Branch Stock Account, Branch Profit & Loss Account, Branch Debtors and Branch Expenses Account by adopting the Stock and Debtors Method and (c) Memorandum Branch Trading and Profit & Loss Account to prove the results as disclosed by the Branch Account.*

Solution

(a) Debtors Method

Delhi Branch Account

2012			₹	₹	2012			₹	₹
Jan. 1	To	Balance b/d			Dec. 31	By	Bank		
		Stock	7,000				Cash Sales	17,500	
		Debtors	12,600				Cash from		
		Petty cash	200	19,800			Sundry Debts.	28,500	46,000
Dec. 31	To	Goods sent to Branch A/c		26,000		By	Goods sent to Branch A/c – Returns to H.O.		1,000
	To	Bank:				By	Balance c/d		
		Salaries & Wages	6,200				Stock	6,500	
		Rent & Rates	1,200				Debtors	9,800	
		Sundry Exp.	800	8,200			Petty Cash	100	16,400
	To	Balance being Profit carried to (H.O.) P & L A/c		9,400					
				63,400					63,400
Jan. 1, 2013	To	Balance b/d		16,400					

(b) Stock and Debtors Method

Branch Stock Account

2012			₹	2012				₹	₹
Jan. 1	To	Stock	7,000	Dec. 31	By	Sales:			
Dec. 31	To	Goods Sent to Branch A/c	26,000			Cash		17,500	
						Credit	28,400		

	To	Branch P & L A/c	19,900			*Less:* Return	(500)	27,900	45,400
					By	Goods sent to Branch A/c - Return			1,000
					By	Balance c/d (Stock)			6,500
			52,900						52,900
2013 Jan. 1	To	Balance b/d	6,500						

Delhi Branch Debtors Account

2012			₹	2012			₹
Jan. 1	To	Balance b/d	12,600	Dec. 31	By	Cash	28,500
Dec. 31	To	Sales	28,400		By	Returns	500
					By	Allowances	200
					By	Discounts	1,400
					By	Bad debts	600
					By	Balance c/d	9,800
			41,000				41,000
2013 Jan. 1	To	Balance b/d	9,800				

Delhi Branch Expenses Account

2012			₹	2012			₹
Dec. 31	To	Salaries & Wages	6,200	Dec. 31	By	Branch P & L A/c	10,500
	To	Rent & Rates	1,200				
	To	Sundry Expenses	800				
	To	Petty Cash Expenses	100				
	To	Allowances to customers	200				
	To	Discounts	1,400				
	To	Bad Debts	600				
			10,500				10,500

Delhi Branch Profit & Loss Account

2012			₹	2012			₹
Dec. 31	To	Branch Exp. A/c	10,500	Dec. 31	By	Gross Profit b/d	19,900
	To	Net Profit to General P & L A/c	9,400				
			19,900				19,900

(c) Memorandum Branch Trading and Profit and Loss Account

		₹	₹				₹	₹
To	Stock		7,000	By	Sales:			
To	Goods sent				Cash		17,500	
	from H.O.	26,000			Credit	28,400		
	Less: Returns to H.O.	(1,000)	25,000		*Less:* Returns	(500)	27,900	45,400
To	Gross profit c/d		19,900	By	Closing Stock			6,500
			51,900					51,900
To	Salaries & Wages		6,200	By	Gross Profit b/d			19,900
To	Rent & Rates		1,200					
To	Sundry Exp.		800					
To	Petty Cash Exp.		100					
To	Allowances to Customers		200					
To	Discounts		1,400					
To	Bad Debts		600					
To	Net Profit		9,400					
			19,900					19,900

5.2 When goods are invoiced at selling price: It would be obvious that if Branch Account is debited with the sales price of goods and subsequent to the debit being raised there is a change in the sale price, the amount of debit either has to be increased or reduced on a consideration of the quantity of unsold stock that was there at the branch at the time the change took place. Such an adjustment will be necessary as often as the change in sale price occurs.

Moreover the amount of anticipatory profit, included in the value of unsold stock with the branch at the close of the year will have to be **eliminated** before the accounts of the branch are incorporated with that of the head office. This will be done by creating a reserve.

It may also be necessary to adjust the value of closing stock on account of the physical losses of stock due to either pilferage or wastages which may have occurred during the year. The last mentioned adjustments are made by debiting the cost of the goods to Goods Lost Account and the amount of loading (included in the lost goods), to the Branch Adjustment Account. The three different methods that are usually adopted for maintaining accounts on this basis are described below:

Stock and Debtors Method

Under this method, when goods are invoiced at selling price, one additional account ie. 'Branch Adjustment account' is also prepared in addition to all the accounts which are maintained on cost basis. (Refer para 5.1)

- .When goods are invoiced at selling price, the following points should be kept in mind under this method:

(*i*) Journal Entries:

₹ Transaction	Accounts debited	Accounts credited
(*a*) Sale price of the goods sent from H.O. to the Branch	Branch Stock A/c (at selling price)	(*i*) Goods sent to Branches A/c with cost of the goods sent. (*ii*) Branch Adjustment A/c (with the loading *i.e.*, Difference between the selling and cost price).
(*b*) Return of goods By the Branch to H.O.	(*i*) Goods sent to Branch A/c (with the cost of goods returned). (*ii*) Branch Adjustment A/c (with the loading)	Branch Stock A/c
(*c*) Cash sales at the Branch	Cash/Bank A/c	Branch Stock A/c
(*d*) Credit Sales at the Branch	Branch Debtors A/c	Branch Stock A/c
(*e*) Goods returned to Branch by customers	Branch Stock A/c	Branch Debtors A/c (at selling price)
(*f*) Goods lost in Transit or stolen	(*i*) Goods Lost in Transit A/c or Goods Stolen A/c (with cost of the goods) (*ii*) Branch Adjustment A/c (with the loading)	Branch Stock A/c

(*ii*) Closing Stock

The balance in the Branch Stock Account at the close of the year normally should be equal to the unsold stock at the Branch valued at sale price. But quite often the value of stock actually held at the branch is either more or less than the balance of the Branch Stock Account. In that event it will be necessary that the balance in the Branch Stock Account is increased or reduced by debit or credit to Goods Lost Account (at cost price of goods) and Branch Adjustment Account (with the loading). The Stock Account at selling price, thus reveals loss of stock (or surplus) and serves as a check on the branch in this respect.

The discrepancy in the amount of balance in the Branch Stock Account and the value of stock actually in hand, valued at sale price, may be the result of one or more of the under-mentioned factors:

- An error in applying the percentage of loading.
- Goods having been sold either below or above the established selling price.
- A Commission to adjust returns or allowances.
- Physical loss of stock due to natural causes or pilferage.
- Errors in Stock-taking.

For example, the balance brought down in the Branch Stock Account is ₹ 100 in excess of the value of stock actually held by the branch when the goods were invoiced by the head office to the branch at 20% above cost and the discrepancy is either due to pilferage or loss by fire, the actual loss to the firm would be ₹ 80, since 20% of the invoice price would represent the element of profit. The adjusting entry in such a case would be:

		Dr. ₹	*Cr.* ₹
Goods Lost A/c	*Dr.*	*80*	
Branch Adjustment A/c	*Dr.*	*20*	
To Branch Stock A/c			*100*

If on the other hand, a part of the sale proceeds has been misappropriated, then the adjusting entry would be:

		Dr.	*Cr.*
Loss by theft A/c	*Dr.*	*XX*	
Branch Adjustment A/c	*Dr.*	*XX*	
To Branch Stock A/c			*XX*

Rebates and allowances allowed to customers are adjusted by debiting the amounts of such allowances to Branch Adjustment Account and crediting Branch Stock Account. But, if the gross amount of sale has been debited to Branch debtors Account, this account would be credited instead of Branch Stock Account, since the last mentioned account would have already received credit for the full value.

In the Goods Sent to Branch Account, the cost of the goods sent out to a branch for sale is credited by debiting Branch Stock Account. Conversely, the cost of goods returned by the branch is debited to this account. As such the balance in the account at the end of the year will be the cost of goods sent to the branch; therefore, it will be transferred either to the Trading Account or to Purchases Account of the head office.

The amount of profit anticipated on sale of goods sent to the branch is credited to the Branch Adjustment Account and conversely, the amount of profit not realized in respect of goods returned by the branch to head office or that in respect to stock remaining unsold with the branch at the close of the year is debited. The balance in this account, at the end of year thus will consist of the amount of Gross Profit earned on sale by the branch. On that account, it will be transferred to the Branch Profit and Loss Account.

(***iii***) ***Elimination of unrealised profit in the closing stock***: The balance in the Branch Stock account would be at the **sale price**; therefore it would be necessary to eliminate the element of profit included in such closing stock. This is done by creating a reserve against unrealised profit, by debiting the Branch Adjustment Account and crediting Stock Reserve Account with an amount equal to the difference in the cost and selling price of unsold stock. Sometimes instead of opening a separate account in respect of the reserve, the amount of the difference is credited to Branch Stock Account. In that case, the credited balance of such a reserve is also carried forward separately, along with the debit balance in the Branch Stock Account; the difference between the two would be the value of stock at cost. In either case, the credit balance will be deducted out of the value of closing stock for the purpose of disclosure in the balance sheet, so that the stock is shown at cost.

An Alternative method: Where the gross profit of each branch is not required to be ascertained separately, although the selling price is uniform, the amount of goods sent to the branch is recorded only in two accounts namely - Branch Stock Account and Goods Sent to Branch A/c.

In this method, at the end of the year the Branch Stock Account is closed by transfer of the balance representing the value of closing stock, at sale price, to the **Goods Sent to Branch Account.** This has the effect of altogether eliminating from the books the value of stock at the branch. The balance of Goods sent to Branch Account is afterwards transferred to the **Trading Account** representing the net sale price of goods sold at the branch. In that case, the value of closing stock at the branch at cost will be subsequently introduced in the Trading Account together with that of closing stock at the head office.

Illustration 6

Harrison of Chennai has a branch at New Delhi to which goods are sent @ 20% above cost. The branch makes both cash and credit sales. Branch expenses are met partly from H.O. and partly by the branch. The statement of expenses incurred by the branch every month is sent to head office for recording.

Following further details are given for the year ended 31st December, 2012:

	₹
Cost of goods sent to Branch at cost	*2,00,000*
Goods received by Branch till 31-12-2012 at invoice price	*2,20,000*
Credit Sales for the year @ invoice price	*1,65,000*
Cash Sales for the year @ invoice price	*59,000*
Cash Remitted to head office	*2,22,500*
Expenses paid by H.O.	*12,000*
Bad Debts written off	*750*

Balances as on	*1-1-2012*	*31-12-2012*
	₹	*₹*
Stock	*25,000 (Cost)*	*28,000 (invoice price)*
Debtors	*32,750*	*26,000*
Cash in Hand	*5,000*	*2,500*

Show necessary ledger accounts in the books of the head office and determine the Profit and Loss of the Branch for the year ended 31st December, 2012.

Solution

Books of Harrison

Branch Stock Account

	₹		₹
To Balance b/d	30,000	By Branch Debtors	1,65,000
To Goods Sent to Branch A/c	2,40,000	By Branch Bank	59,000
To Branch Adjustment A/c	2,000	By Balance c/d	
(Excess of sale		Goods in Transit	
over invoice price)		(₹ 2,40,000 –₹ 2,20,000)	20,000
		Stock at Branch	28,000
	2,72,000		2,72,000

Branch Debtors Account

	₹		₹
To Balance b/d	32,750	By Bad debts written off	750
To Branch Stock	1,65,000	By Branch Cash-collection (bal.fig.)	1,71,000
		By Balance c/d	26,000
	1,97,750		1,97,750

Branch Cash Account

	₹		₹
To Balance b/d	5,000	By Bank Remit to H.O.	2,22,500
To Branch Stock	59,000	By Branch profit & loss A/c	12,000
To Bank (as per contra)	12,000	(exp. paid by H.O.)	
To Branch Debtors	1,71,000	By Branch profit & loss A/c	10,000
		[Bal. fig. (exp. paid by Branch)]	
		By Balance c/d	2,500
	2,47,000		2,47,000

Branch Adjustment Account

	₹		₹
To Stock Reserve (on closing stock (48,000 × 1/6)	8,000	By Stock Reserve opening	5,000
To Gross Profit c/d	39,000	By Goods sent to Branch A/c	40,000
		By Branch Stock A/c	2,000
	47,000		47,000

Branch Profit and Loss Account

To Branch Expenses (paid by HO: ₹ 12,000 and paid by Branch ₹ 10,000)	22,000	By Gross Profit b/d	39,000
To Branch Debtors-Bad debts	750		
To Net Profit	16,250		
	39,000		39,000

Goods Sent to Branch Account

	₹		₹
To Branch Adjustment A/c	40,000	By Branch to Stock A/c	2,40,000
To Purchase A/c - Transfer	2,00,000		
	2,40,000		2,40,000

Debtors Method

Under this method, the principal accounts that will be maintained are:

- The Branch Account;
- The Goods Sent to Branch Account; and
- The Stock Reserve Account.

Entries in these accounts will be made in the following manner:

	Transaction	**Account debited**	**Account credited**
(*a*)	Goods sent to Branch at selling price	Branch A/c	Goods Sent to Branch A/c
(*b*)	'Loading being the difference between selling price and cost of goods	Goods Sent to Branch A/c	Branch A/c
(*c*)	Returns to H.O. at selling price	Goods Sent to Branch A/c	Branch A/c
(*d*)	'Loading' in respect of goods returned to H.O.	Branch A/c	Goods Sent to Branch A/c
(*e*)	'Loading' included in the	Stock Reserve A/c	Branch A/c

	opening stock to reduce it		
(*f*)	Closing stock at selling price	Branch Stock A/c	Branch A/c
(*g*)	'Loading' included in closing stock to reduce it to cost	Branch A/c	Stock Reserve A/c

It will be observed that entries in the Branch Account in respect of goods sent to a branch or returned by it, as well as those for the opening and closing stock, will be at selling price. In consequence, the Branch Account is maintained at selling price.

Hence the Branch Account will not correctly show the trading profit of the Branch unless these amounts are adjusted to cost. Such an adjustment is effected by making contra entries in 'Goods Sent to Branch A/c' and 'Stock Reserve Account'. In respect of closing stock at branch for the purpose of disclosure in the Balance Sheet, the credit balance in the 'Stock Reserve Account' at the end of the year will be deducted from the value of the closing stock, so as to reduce it to close; it will be carried forward as a separate balance to the following year, for being transferred to the credit of the Branch Account.

Illustration 7

Take figures from Illustration 5 and prepare branch account following debtors' method.

Solution

Books of Harrison
New Delhi Branch Account

	₹			₹
To Balance b/d		By Balance b/d		
Stock	30,000	Stock Reserve		5,000
Debtors	32,750	By Goods Sent to Branch A/c		40,000
Cash	5,000	By Bank-Remittance		
To Goods Sent to Branch A/c	2,40,000	received from the Branch		
To Bank (Exp. paid by H.O.)	12,000	Cash sales	59,000	
To Net Profit Transferred to	16,250	Debtors Collection	1,63,500	2,22,500
H.O. Profit and Loss A/c		(Net of expense)		
To Balance c/d (Stock reserve		By Balance c/d		
on closing stock)	8,000	Stock (including Transit)		48,000
		Debtors		26,000
		Cash		2,500
	3,44,000			3,44,000

Trading and Profit and Loss Account (Final Accounts) Method

All items of memorandum Branch Trading and Profit and Loss Account are to be converted into cost price if the goods are invoiced to branch at selling price. Other points will remain same as already discussed in Para 5.1 for this method if goods are invoiced at cost.

Illustration 8

Following is the information of the Jammu branch of Best New Delhi for the year ending 31st March, 2012 from the following:

(1) Goods are invoiced to the branch at cost plus 20%.

(2) The sale price is cost plus 50%.

(3) Other information:

	₹
Stock as on 01.04.2011(invoice price)	*2,20,000*
Goods sent during the year(invoice price)	*11,00,000*
Sales during the year	*12,00,000*
Expenses incurred at the branch	*45,000*

Ascertain

(i) the profit earned by the branch during the year.

(ii) branch stock reserve in respect of unrealized profit.

Answer

(i) Calculation of profit earned by the branch

In the books of Jammu Branch
Trading Account And Profit and Loss Account

Particulars	*Amount* ₹	*Particulars*	*Amount* ₹
To Opening stock	2,20,000	By Sales	12,00,000
To Goods received by Head office	11,00,000	By Closing stock (Refer W.N.)	3,60,000
To Expenses	45,000		
To Net profit	1,95,000		
	15,60,000		15,60,000

(ii) Stock reserve in respect of unrealised profit

= ₹ 3,60,000 x (20/120) = ₹ 60,000

Working Note:

Cost Price	100	
Invoice Price	120	
Sale Price	150	

Calculation of closing stock at invoice price	₹	
Opening stock at invoice price	2,20,000	
Goods received during the year at invoice price	11,00,000	
	13,20,000	
Less : Cost of goods sold at invoice price	(9,60,000)	[12,00,000 x (120/150)]
Closing stock	3,60,000	

Illustration 9

Sell Well who carried on a retail business opened a branch X on January 1st, 2013 where all sales were on credit basis. All goods required by the branch were supplied from the Head Office and were invoiced to the branch at 10% above cost.

The following were the transactions:

	Jan. '2013	*Feb. 2013*	*March 2013*
	₹	₹	₹
Goods sent to Branch (Purchase Price)	*40,000*	*50,000*	*60,000*
Sales as shown by the branch monthly report	*38,000*	*42,000*	*55,000*
Cash received from Debtors and remitted to H.O.	*20,000*	*51,000*	*35,000*
Returns to H.O. (Invoice price to Branch)	*1,200*	*600*	*2,400*

The stock of goods held by the branch on March 31, 2013 amounted to ₹53,400 at invoice to branch.

Record these transactions in the Head Office books, showing balances as on 31st March, 2013 and the branch gross profit for the three months ended on that date.

All workings should form part of your solution.

Solution

Books of Sell Well
Branch Account

	₹			₹
To Goods sent to Branch A/c $\left[\frac{110}{100} \times 1{,}50{,}000\right]$	1,65,000	By Cash-collected from debts		1,06,000
		By Goods sent to Branch-returns		4,200
To Stock Reserve (W.N.2)	4,855	By Goods sent to Branch (W.N. 1)		14,618
To Profit (bal.) transferred to General Profit & Loss A/c	37,363	By Balance c/d		
		Stock	53,400	
		Debtors	29,000	82,400
	2,07,218			2,07,218

Memorandum Branch Debtors Account

	₹		₹
To Balance b/d	-	By Cash/Bank	1,06,000
To Sales	1,35,000	By Balance c/d	29,000
	1,35,000		1,35,000

Goods Sent to Branch Account

	₹		₹
To Branch A/c (Returns)	4,200	By Branch A/c	1,65,000
To Branch A/c (Loading)	14,618		
To Purchases A/c	1,46,182		
	1,65,000		1,65,000

Working Notes:

1. Loading on Goods sent to Branch = 1/11 of (₹ 1,65,000 – ₹ 4,200) = ₹ 14,618
2. Stock Reserve = 1/11 of 53,400 = ₹ 4,855

Illustration 10

Hindustan Industries Mumbai has a branch in Cochin to which office goods are invoiced at cost plus 25%. The branch sells both for cash and on credit. Branch Expenses are paid direct from head office, and the Branch has to remit all cash received into the Head Office Bank Account.

From the following details, relating to calendar year 2012, prepare the accounts in the Head Office Ledger and ascertain the Branch Profit. Branch does not maintain any books of account, but sends weekly returns to the Head Office:

	₹
Goods received from Head Office at invoice price	*6,00,000*
Returns to Head Office at invoice price	*12,000*
Stock at Cochin as on 1st Jan., 2012	*60,000*
Sales in the year - Cash	*2,00,000*
Credit	*3,60,000*
Sundry Debtors at Cochin as on 1st Jan. 2012	*72,000*
Cash received from Debtors	*3,20,000*
Discount allowed to Debtors	*6,000*
Bad debts in the year	*4,000*
Sales returns at Cochin Branch	*8,000*

Rent, Rates, Taxes at Branch	*18,000*
Salaries, Wages, Bonus at Branch	*60,000*
Office Expenses	*6,000*
Stock at Branch on 31st Dec. 2012 at invoice price	*1,20,000*

Solution

Books of Hindustan Industries, Mumbai
Cochin Branch Stock Account

	₹		₹
To Balance b/d	60,000	By Bank A/c (Cash sales)	2,00,000
To Goods sent to Branch A/c	6,00,000	By Branch Debtors (Cr. sales)	3,60,000
To Branch Debtors A/c (sales return)	8,000	By Goods sent to Branch (Ret. to H.O.)	12,000
To Branch P & L A/c (surplus)	24,000	By Balance c/d (closing stock)	1,20,000
	6,92,000		6,92,000

Cochin Branch Stock Adjustment Account

	₹		₹
To Goods sent to Branch A/c (1/5 of ₹ 12,000) (on returns)	2,400	By Balance b/d (1/5 of ₹ 60,000)	12,000
To Branch P & L A/c (Profit on sale at invoice price)	1,05,600	By Goods sent to Branch A/c (1/5 of ₹ 6,00,000)	1,20,000
To Balance c/d (1/5 of ₹ 1,20,000)	24,000		
	1,32,000		1,32,000

Goods Sent to Branch Account

	₹		₹
To Cochin Branch Stock Adjustment A/c	1,20,000	By Cochin Branch Stock A/c	6,00,000
To Cochin Branch Stock A/c (Ret.)	12,000	By Cochin Branch Stock Adj. A/c	2,400
To Purchases A/c	4,70,400		
	6,02,400		6,02,400

Branch Debtors Account

	₹		₹
To Balance b/d	72,000	By Bank	3,20,000
To Branch Stock A/c	3,60,000	By Branch P & L A/c	

		By Discount 6,000	
		By Bad Debts 4,000	10,000
		By Branch Stock (Sales Returns.)	8,000
		By Balance c/d	94,000
	4,32,000		4,32,000

Branch Expenses Account

	₹		₹
To Bank A/c (Rent, Rates & Taxes)	18,000	By Branch Profit & Loss A/c (Transfer)	84,000
To Bank A/c (Salaries & Wages)	60,000		
To Bank A/c (office exp.)	6,000		
	84,000		84,000

Branch Profit & Loss Account for the year ending 31st Dec. 2012

	₹		₹
To Branch Expenses A/c	84,000	By Branch Stock Adj. A/c	1,05,600
Discount 6,000		By Branch stock A/c	
Bad debts 4,000	10,000	(Sale over invoice price)	24,000
To Net Profit transferred to			
Profit & Loss A/c	35,600		
	1,29,600		1,29,600

Illustration 11

Arnold of Delhi, trades in Ghee and Oil. It has a branch at Lucknow. He dispatches 25 tins of Oil @ ₹ 1,000 per tin and 15 tins of Ghee @ ₹ 1,500 per tin on 1st of every month. The branch incurs some expenditure which is met out of its collections; this is in addition to expenditure directly paid by Head Office.

Following are the other details:

		Delhi	*Lucknow*
		₹	₹
Purchases	*Ghee*	*14,75,000*	-
	Oil	*29,32,000*	-
Direct expenses		*3,83,275*	-
Expenses paid by H.O.		-	*14,250*
Sales	*Ghee*	*18,46,350*	*3,42,750*
	Oil	*27,41,250*	*3,15,730*
Collection during the year (including Cash Sales)		-	*6,47,330*

Remittance by Branch to Head Office		*-*	*6,13,250*

	(Delhi)	
Balance as on:	*1-1-2012*	*31-12-2012*
Stock : Ghee	*1,50,000*	*3,12,500*
Oil	*3,50,000*	*4,17,250*
Debtors	*7,32,750*	*-*
Cash on Hand	*70,520*	*55,250*
Furniture & Fittings	*21,500*	*19,350*
Plant/Machinery	*3,07,250*	*7,73,500*

	(Lucknow)	
Balance as on:	*1-1-2012*	*31-12-2012*
Stock : Ghee	*17,000*	*13,250*
Oil	*27,000*	*44,750*
Debtors	*75,750*	*-*
Cash on Hand	*7,540*	*12,350*
Furniture & Fittings	*6,250*	*5,625*
Plant/Machinery	*-*	

Addition to Plant/Machinery on 1-1-2012 ₹ 6,02,750.

Rate of Depreciation: Furniture / Fittings @ 10% and Plant / Machinery @ 15% (already adjusted in the above figures).

The Branch Manager is entitled to 10% commission after charging such commission whereas, the General Manager is entitled to 10% commission on overall company profits after charging such commission. General Manager is also entitled to a salary of ₹ 2,000 p.m. General expenses incurred by H.O. ₹ 24,000.

Prepare Branch Account in the head office books and also prepare the Arnold's Trading and Profit and Loss A/c (excluding branch transactions).

Solution

In the books of Arnold

Lucknow Branch Account

	₹		₹
To Balance b/d		By Bank (Remittance to H.O.)	6,13,250
Opening stock:		By Balance c/d	
Ghee	17,000	Closing stock:	
Oil	27,000	Ghee	13,250
Debtors	75,750	Oil	44,750
Cash on hand	7,540	Debtors (W.N. 1)	86,900
Furniture & fittings	6,250	Cash on hand (W.N. 2)	12,350

To Goods sent to Branch A/c		Furniture & fittings	5,625
Ghee	2,70,000		
Oil	3,00,000		
To Bank (Expenses paid by H.O.)	14,250		
To Branch Manager commission			
(₹ 58,335 × 1/11)	5,303		
To Net Profit transferred			
to General P & L A/c	53,032		
	7,76,125		7,76,125

Arnold

Trading and Profit and Loss account for the year ended 31st December, 2012

(Excluding branch transactions)

		₹		₹
To Opening Stock:			By Sales:	
Ghee		1,50,000	Ghee	18,46,350
Oil		3,50,000	Oil	27,41,250
To Purchases:			By Closing Stock:	
Ghee	14,75,000		Ghee	3,12,500
Less: Goods sent to Branch	(2,70,000)	12,05,000	Oil	4,17,250
Oil	29,32,000			
Less: Goods sent to Branch	(3,00,000)	26,32,000		
To Direct Expenses		3,83,275		
To Gross Profit		5,97,075		
		53,17,350		53,17,350
To Manager's Salary		24,000	By Gross Profit	5,97,075
To General Expenses		24,000	By Branch Profit transferred	53,032
To Depreciation				
Furniture @ 10%	2,150			
Plant & Machinery @ 15%	1,36,500	1,38,650		
To General Manager's Commission @ 10% (*i.e.*, 4,63,457 × 1/11)		42,132		
To Net profit		4,21,325		
		6,50,107		6,50,107

Working Notes:

(1) Debtors Account

	₹		₹
To Balance b/d	75,750	By Cash Collections	6,47,330
To Sales made during the year:		By Balance c/d	86,900
Ghee	3,42,750		
Oil	3,15,730		
	7,34,230		7,34,230

(2) Branch Cash Account

	₹		₹
To Balance b/d	7,540	By Remittance	6,13,250
To Collections	6,47,330	By Exp. (Balance fig.)	29,270
		By Balance c/d	12,350
	6,54,870		6,54,870

5.3 Goods invoiced at wholesale price to retail branches: Under this method, the Head Office (particularly, the manufacturing concern) supplies goods to its retail branches at wholesale price which is cost plus wholesale profit. The profit attributable to such branches is the difference between the sale proceeds of goods at the shops and the wholesale price of the goods sold. For the purpose, it is assumed that the manufacturer would always be able to sell the goods on wholesale terms and thereby realizes profit equal to the difference between the wholesale price and the cost. Many concerns, therefore, invoice goods to such shops at wholesale price and determine profit or loss on sale of goods on this basis. Accordingly, Branch Stock Account or the Trading Account is debited with:

(*a*) the value of opening stock at the Branch; and

(*b*) price of goods sent during the year at wholesale price.

It is credited by:

(*a*) sales effected at the shop; and

(*b*) closing stock of goods valued at wholesale price.

The value of goods lost due to accident, theft etc. also is credited to the Branch Stock Account or Trading Account calculated at the **wholesale price**. At this stage, the Branch Stock or Trading Account will reveal the amount of gross profit (or loss). It is transferred to the Branch Profit and Loss Account. On further being debited with the expenses incurred at the shop and the wholesale price of goods lost, the Branch Profit and Loss Account will disclose the net profit (or loss) at the shop.

Since the closing stock at the branch has to be valued at wholesale price, it would be necessary to create a stock reserve equal to the difference between its wholesale price and its cost (to the head office) by debiting the amount in the *Head Office Profit and Loss Account.* This Stock Reserve is carried down to the next year and then transferred to the credit of the (Head Office) Profit and Loss Account.

Illustration 12

M/s Rahul operates a number of retail outlets to which goods are invoiced at wholesale price which is cost plus 25%. These outlets sell the goods at the retail price which is wholesale price plus 20%.

Following is the information regarding one of the outlets for the year ended 31.3.2012:

	₹
Stock at the outlet 1.4.11	*30,000*
Goods invoiced to the outlet during the year	*3,24,000*
Gross profit made by the outlet	*60,000*
Goods lost by fire	*?*
Expenses of the outlet for the year	*20,000*
Stock at the outlet 31.3.12	*36,000*

You are required to prepare the following accounts in the books of Rahul Limited for the year ended 31.3.12 :

(a) Outlet Stock Account.

(b) Outlet Profit & Loss Account.

(c) Stock Reserve Account.

Answer

Outlet Stock Account

	₹		₹
To Balance b/d	30,000	By Sales (Working Note 1)	3,60,000
To Goods sent to outlet	3,24,000	By Goods lost by fire	18,000
To Gross Profit c/d	60,000	By Balance c/d	36,000
	4,14,000		4,14,000

Outlet Profit & Loss Account

	₹		₹
To Expenses	20,000	By Gross Profit b/d	60,000
To Goods lost by fire (W.N. 2)	18,000		

To Profit transferred	22,000		
	60,000		60,000

Stock Reserve Account

	₹		₹
To HO P & L A/c – Transfer	6,000	By Balance b/d	6,000
To Balance c/d (Stock Res. required)	7,200	By HO P&L A/c (W.N. 3)	7,200
	13,200		13,200

Working Notes :

			₹
(1)	Wholesale Price	100+25	= 125
	Retail Price	125 + 20%	= 150
	Gross Profit at the outlet		
	Wholesale Price – Retail Price	(150 – 125)	25

Retail sales value = $60,000 \times \frac{150}{25}$ = ₹ 3,60,000

(2) Goods lost by fire

Opening Stock + Goods Sent + Gross Profit – Sales – Closing Stock

30,000 + 3,24,000 + 60,000 – 3,60,000 – 36,000 = ₹ 18,000

(3) Stock Reserve

Opening Stock = $30,000 \times \frac{25}{125}$ = ₹ 6,000

Closing Stock = $36,000 \times \frac{25}{125}$ = ₹ 7,200

6. Accounting for Independent Branches

When the size of the business is big, it is desirable that the branch maintains complete records of its transactions. These branches are called independent branches and each independent branch maintains comprehensive account books for recording their transactions; therefore a separate trial balance of each branch can be prepared. The head office maintains one ledger account for each such branch, wherein all transactions between the head office and the branches are recorded.

Salient features of accounting system of an independent branch are as follows:

1. Branch maintains its entire books of account under double entry system.

2. Branch opens in its books a Head Office account to record all transactions that take place between Head Office and branch. The Head Office maintains a Branch account to record these transactions.
3. Branch prepares its Trial Balance, Trading and profit and loss Account at the end of the accounting period and sends copies of these statements to Head Office for incorporation.
4. After receiving the final statements from branch, Head Office reconciles between the two – Branch account in Head Office books and Head Office account in Branch books.
5. Head office passes necessary journal entries to incorporate branch trial balance in its books.

The Head Office Account in branch books and Branch Account in head office books is maintained respectively.

	Transactions	Head office books		Branch books	
(*i*)	Dispatch of goods to branch by H.O.	Branch A/c To Good sent to Branch A/c	Dr.	Goods received. from H.O. A/c To Head Office A/c	Dr.
(*ii*)	When goods are returned by the Branch to H.O.	Goods sent to Branch A/c To Branch A/c	Dr.	Head Office A/c To Goods recd. from H.O. A/c	Dr.
(*iii*)	Branch Expenses are paid by the Branch	No Entry		Expenses A/c To Cash A/c	Dr.
(*iv*)	Branch Expenses paid by H.O.	Branch A/c To Bank	Dr.	Expenses A/c To Head Office A/c	Dr.
(*v*)	Outside purchases made by the Branch	No Entry		Purchases A/c To Bank (or) Crs. A/c	Dr.
(*vi*)	Sales effected by the Branch	No Entry		Cash or Debtors A/c To Sales	Dr.
(*vii*)	Collection from Debtors of the Branch recd. by H.O.	Cash or Bank A/c To Branch A/c	Dr.	Head office A/c To Sundry Drs. A/c	Dr.
(*viii*)	Payment by H.O. for purchase made by Branch	Branch A/c To Bank	Dr.	Purchase (or) Sundry Creditors A/c To Head Office	Dr.
(*ix*)	Purchase of Asset by Branch	No Entry		Sundry Assets To Bank (or) Liability	Dr.
(*x*)	Asset purchased by the Branch but Asset A/c retained at H.O. books	Branch Asset A/c To Branch A/c	Dr.	Head office To Bank (or) Liability	Dr.
(*xi*)	Depreciation on (*x*)	Branch A/c	Dr.	Depreciation A/c	Dr.

	above	To Branch Asset	To Head Office A/c
(*xii*)	Remittance of funds by H.O. to Branch	Branch A/c Dr. To Bank	Bank A/c Dr. To Head Office
(*xiii*)	Remittance of funds by Branch to H.O.	Reverse entry of(*xii*) above	Reverse entry of (*xii*) above
(*xiv*)	Transfer of goods from one Branch to another branch	(Recipient) Branch A/c Dr. To Supplying Branch A/c	Supplying Branch H.O. A/c Dr. To Goods Received from H.O. A/c Recipient Branch Goods Received from H.O. A/c Dr. To Head Office A/c

Students may find a few further practical situations and it is hoped that they can pass entries on the basis of accounting principles explained above.

The final result of these adjustments will be that so far as the Head Office is concerned, the branch will be looked upon either as a debtor or creditor, as a debtor if the amount of its assets is in excess of its liabilities and as a creditor if the position is reverse.

A debit balance in the Branch Account should always be equal to the net assets at the branch. The important thing to remember, when independent sets of accounts are maintained, is that the branch and head office books are connected with each other only through the medium of the Branch and the Head Office Account which are converse of each other.; also when accounts of the branch and head office are consolidated both the Branch and Head Office Accounts will be eliminated.

7. Adjustment and Reconciliation of Branch and Head Office Accounts

If the branch and the head office accounts, converse of each other, do not tally, these must be **reconciled** before the preparation of the final accounts of the concern as a whole.

For example if Head Office has sent goods worth ₹ 50,000 but the branch has received till the closing date goods only ₹ 40,000, then the branch should treat ₹ 10,000 as goods in transit and should pass the following entry :

		Dr.	Cr.
Goods in transit A/c	Dr.	10,000	
To Head Office A/c			10,000

However, there will be no entry in Head office books being the point where the event has been recorded in full, hence no further entries in Head office books.

7.1 Reasons for Disagreement: Following are the possible reasons for the disagreement between Branch A/c in Head office books and Head office A/c in Branch books on the closing date:

- Goods dispatched by the Head office not received by the branch. These goods may be in transit or loss in transit.
- Goods returned by the branch to Head Office may have been received by the H.O. Again, these goods may be in transit or lost in transit.
- Amount remitted by Head office to branch or *vice versa* remaining in transit on the closing date.
- Receipt of income or payment or expenses relating to the Branch transacted by the head office or *vice versa*, hence not recorded at the respective ends wherein they are normally to be recorded.

The technique of reconciliation has been illustrated through the example given below :

	Head office		Branch	
	Dr.	Cr.	Dr.	Cr.
Goods sent to Branch		1,50,000	-	
Goods recd. from H.O. A/c		-	1,40,000	
Branch A/c	1,12,000			
Head office A/c	-	-	-	78,500

On analysis of Branch A/c in Head office books and Head office A/c in branch books, you find:

- ₹ 15,000 remitted by the branch has not been received, hence not recorded in the head office books.
- Direct collection of ₹ 10,500 from a customer of the branch by Head office not informed to the branch, hence not recorded by the branch.
- A sum of ₹ 14,500 paid by branch to the suppliers of head office not recorded at Head office.
- Head office expenditure allocation to the branch ₹12,000 not recorded in the branch.
- ₹ 7,500 being FD interest of head office received by the branch on oral instructions from H.O., not recorded in the head office books.

			Head Office Books			Branch Books	
			Dr. ₹	Cr. ₹		Dr. ₹	Cr. ₹
(*i*)	*Goods in transit* (₹ 10,000)		-	-	Goods in Transit A/c To Head office A/c	10,000	 10,000
(*ii*)	*Cash in Transit*:	Cash in Transit A/c To Branch A/c	15,000	 15,000	(No Entry)		
(*iii*)	*Direct Collection by H.O. on behalf of the Branch*				Head Office A/c To Debtors A/c	10,500	 10,500
(*iv*)	*Direct payment of*	Sundry Crs. A/c	14,500				

	₹ 14,500 by Branch on behalf of H.O	To Branch A/c		14,500			
(*v*)	*Expenditure Allocated to Branch*				Branch Exp. A/c To H.O. A/c	12,000	12,000
(*vi*)	*Fixed Deposit interest of ₹ 7,500 directly received by the Branch*	Branch A/c To Sundry Income	7,500	7,500			

In Branch Books

Head Office Account

	₹		₹
To Sundry Debtors A/c	10,500	By Balance b/d	78,500
To Balance c/d	90,000	By Goods in transit	10,000
		By Branch expenses	12,000
	1,00,500		1,00,500
		By Balance b/d	90,000

In the Books of Head Office

Branch A/c

	₹		₹
To Balance b/d	1,12,000	By Cash in Transit	15,000
To Sundry Income	7,500	By Sundry Creditors	14,500
		By Balance c/d	90,000
	1,19,500		1,19,500
To Balance b/d	90,000		

Important Points to be noted:

(*i*) the balance of Head Office A/c in Branch books and Branch A/c in Head Office books have tallied.

(*ii*) Adjustment are made only at the point:

Where the recording has been omitted, and

Other than the point where action has been effected.

7.2 Other points

(1) Inter-Branch Transactions

Inter-branch transactions are usually adjusted as if they were entered into only with the head office. It is a very convenient method of treating such transaction especially where the number of branches are large. Suppose Kolkata Branch incurred an expenditure on advertisement of ₹ 1,000 on account of Delhi Branch, the entries that would be made in such a case would be as follows:

		Dr.	Cr.
		₹	
In Kolkata Books:			
Head Office A/c	Dr.	1,000	
To Cash			1,000
In Delhi Books:			
Advertisement A/c	Dr.	1,000	
To H.O. A/c			1,000
In H.O. Books:			
Delhi Branch A/c	Dr.	1,000	
To Kolkata Branch A/c			1,000

(2) **Fixed Assets**

Often the accounts of fixed assets of a branch are kept in the head office books; in such a case, at the end of the year, the amount of depreciation on the assets is debited to the branch concerned by recording the following entry:

Branch Account Dr.

To Branch Asset Account

The branch will pass the following entry:

Depreciation Account Dr.

To Head Office Account

(3) **Head office Expenses charged to Branch**

Usually the head office has to devote considerable time in attending to the affairs of the branch; on that account, it may decide to raise a charge against the branch in respect of the cost of such time. In such a case the amount is debited to the branch as 'Expenses' and is credited to appropriate revenue head such as Salaries Accounts, General Charges Account, Entertainment Account etc. The branch credits the H.O. Account and debits Expenses Account.

8. Incorporation of Branch Balance in Head Office Books

The method that will be adopted for incorporating the trading result of the branch with that of the head office would depend on whether it is desired to prepare separate Profit & Loss Account and Balance Sheet of the branch and the Head Office or consolidated statement of account of both branch and head office.

In the first-mentioned case, the amount of profit or loss shown by the Profit & Loss Account of the branch only will be transferred to Head office Account in the branch books and a converse entry will be passed in the Head Office books by debit to the Branch Account. This method has already been illustrated above. In such a case, not only the Profit & Loss Account of the branch and that of the head office would be prepared separately but also there would be separate Balance Sheet for the branch and the head office. The branch Balance Sheet would show the amount advanced by the head office to it, as capital. In the head office Balance Sheet, the same amount would be shown as an advance to the branch.

If however, it is desired to prepare a consolidated Profit & Loss Account and Balance Sheet, individual balances of all the revenue accounts would be separately transferred to the Head Office Account by debit or credit in the branch books and the converse entries would be passed in the head office books. The effect thereof will be similar to the amount of net profit or loss of the branch having been transferred since it would be composed of the balances that have been transferred. In case it is also desired that consolidated balance sheet of the branch and the head office should be prepared, it will also be necessary to transfer the balance of assets and liabilities of the branch to the head office. The adjusting entries that would be passed in this respect are shown below:

(*a*) Head Office Account Dr.
    To Asset (individual) Account

(*b*) (Individual) Liability Account Dr.
    To Head Office Account

Converse entries are passed in the head office books.

It is obvious that after afore-mentioned entries have been passed, the Branch Account in the Head Office books and Head Office Account in the branch books will be closed and it will be necessary to restart them at the beginning of the next year.

In consequence, at the beginning of the following year, the under-mentioned entry is recorded by the branch:

Asset Account (In Detail) Dr.
    To Liability Accounts
    To H.O. Account (The difference between assets and liabilities)

Illustration 13

Messrs Ramchand & Co., Hyderabad have a branch in Delhi. The Delhi Branch deals not only in the goods from Head Office but also buys some auxiliary goods and deals in them. They, however, do not prepare any Profit & Loss Account but close all accounts to the Head Office at the end of the year and open them afresh on the basis of advice from their Head Office. The fixed assets accounts are also maintained at the Head Office.

The goods from the Head Office are invoiced at selling prices to give a profit of 20 per cent on the sale price. The goods sent from the branch to Head Office are at cost. From the following prepare Branch Trading and Profit & Loss Account and Branch Assets Account in the Head Office Books.

Trial Balance of the Delhi Branch as on 31-12-2012

Debit	*₹*	*Credit*	*₹*
Head office opening balance on 1-1-12	*15,000*	*Sales*	*1,00,000*
Goods from H.O.	*50,000*	*Goods to H.O.*	*3,000*
Purchases	*20,000*	*Head Office Current A/c*	*15,000*
Opening Stock		*Sundry Creditors*	*3,000*
(H.O. goods at invoice prices)	*4,000*		
Opening Stock of other goods	*500*		
Salaries	*7,000*		
Rent	*3,000*		
Office expenditure	*2,000*		
Cash on Hand	*500*		
Cash at Bank	*4,000*		
Sundry Debtors	*15,000*		
	1,21,000		*1,21,000*

The Branch balances as on 1st January, 2012, were as under: Furniture ₹ 5,000; Sundry Debtors ₹ 9,500; Cash ₹ 1,000, Creditors ₹ 30,000; Stock (H.O. goods at invoice price) ₹ 4,000; other goods ₹ 500. The closing stock at branch of the head office goods at invoice price is ₹ 3,000 and that of purchased goods at cost is ₹ 1,000. Depreciation is to be provided at 10 per cent on branch assets.

Solution

Delhi Branch Trading and Profit & Loss Account
for the year ended 31st Dec., 2012

		₹			₹
To Opening Stock:			By Sales		1,00,000
Head office Goods	3,200		By Goods from Branch		3,000
Others	500	3,700	By Closing Stock :		
To Goods To Branch		40,000	Head Office goods	2,400	
To Purchases		20,000	Others	1,000	3,400
To Gross Profit c/d		42,700			
		1,06,400			1,06,400
To Salaries		7,000	By Gross profit b/d		42,700
To Rent		3,000			
To Office Expenses		2,000			
To Dep. on furniture @ 10%		500			
To Net profit		30,200			
		42,700			42,700

Branch (Fixed) Assets Account (In Head Office Books)

2012		₹	2012		₹
Jan. 1	To Balance b/d	5,000	Dec. 31	By Delhi Branch A/c (Depreciation)	500
				By Balance c/d	4,500
		5,000			5,000
2013					
Jan. 1	To Balance b/d	4,500			

Working Notes:

Cash/Bank Account (Branch Books)

	₹	₹		₹
To Balance b/d		1,000	By Salaries	7,000
To Sales Proceeds			By Rent	3,000
Sales	1,00,000		By Office Exp.	2,000
Opening balance			By Creditors*	47,000
of Debtors	9,500		By Head Office (Balancing fig.)	32,000
	1,09,500		By Cash Balance	500
Less: Closing balance	(15,000)		By Bank Balance	4,000
To Cash Received	94,500	94,500		
		95,500		95,500

*Opening Balance + Purchases – Closing balance = Payment

₹ 30,000 + ₹ 20,000 – ₹ 3,000 = ₹ 47,000.

Trial Balance of Delhi Branch as on 1-1-2012

			Dr. ₹	Cr. ₹
Debtors			9,500	
Cash			1,000	
Stock	H.O. Goods	4,000		
	Others	500	4,500	
Creditors				30,000
Head Office Account			15,000	
			30,000	30,000

Head Office Account

	₹		₹
To Balance (transfer)	15,000	By Goods from Head Office	50,000
To Cash	32,000		
To Goods sent	3,000		
	50,000		50,000

Credit balance in Head Office Account before this transfer will be ₹ 15,000 credit.

Note : Furniture A/c is maintained in Head office books; it is not a part of either opening or closing balance.

Illustration 14

Ring Bell Ltd. Delhi has a Branch at Bombay where a separate set of books is used. The following is the trial balance extracted on 31st December, 2012.

Head Office Trial Balance

	₹	₹
Share Capital (Authorised: 10,000 Equity Shares of ₹ 100 each):		
Issued: 8,000 Equity Shares		*8,00,000*
Profit & Loss Account - 1-1-2012		*25,310*
Interim Dividend paid - Aug. 2012	*30,000*	
General Reserve		*1,00,000*
Fixed Assets	*5,30,000*	
Stock	*2,22,470*	
Debtors and Creditors	*50,500*	*21,900*
Profit for 2012		*82,200*
Cash Balance	*62,730*	
Branch Current Account	*1,33,710*	
	10,29,410	*10,29,410*

Branch Trial Balance

	₹	₹
Fixed Assets	*95,000*	
Profit for 2012		*31,700*
Stock	*50,460*	
Debtors and Creditors	*19,100*	*10,400*
Cash Balance	*6,550*	
Head Office Current Account		*1,29,010*
	1,71,110	*1,71,110*

The difference between the balances of the Current Account in the two sets of books is accounted for as follows:

(a) Cash remitted by the Branch on 31st December, 2012, but received by the Head Office on 1st January 2013 - ₹ 3,000.

(b) Stock stolen in transit from Head Office and charged to Branch by the Head Office, but not credited to Head Office in the Branch books as the Branch Manager declined to admit any liability (not covered by insurance) - ₹ 1,700.

Give the Branch Current Account in Head Office books after incorporating Branch Trial Balance through journal. Also prepare the company's Balance Sheet as on 31st December, 2012.

Solution

The Branch Current Account in the Head Office Books and Head Office Current Account in the Branch Books do not show the same balances. Therefore, in order to reconcile them, the following journal entries will be passed in the Head Office books :

Journal Entries

2012			Dr. ₹	Cr. ₹
Dec., 31	Cash in Transit A/c	Dr.	3,000	
	To Branch Current A/c			3,000
	(Cash sent by the Branch on 31st Dec., 2012 but received at H.O. on 1st Jan., 2013)			
	Loss by theft A/c	Dr.	1,700	
	To Branch Current A/c			1,700
	(Stock lost in transit from H.O. to Branch)			

In order to incorporate, in the H.O. books, the given Branch trial balance which has been drawn up after preparing the Branch Profit & Loss Account, the following journal entries will be necessary:

Journal Entries

2012			₹	₹
Dec. 31	Branch Current Account	Dr.	31,700	
	To Profit & Loss Account			31,700
	(Branch Profit for 2012)			
	Branch Fixed Assets	Dr.	95,000	
	Branch Stock	Dr.	50,460	
	Branch Debtors	Dr.	19,100	
	Branch Cash	Dr.	6,550	

	To Branch Current Account (Branch assets brought into H.O. Books)		1,71,110
	Branch Current A/c Dr.	10,400	
	To Branch Creditors (Branch creditors brought into H.O. Books)		10,400

Branch Current Account

	₹		₹
To Balance b/d	1,33,710	By Cash in transit	3,000
To Profit & Loss A/c	31,700	By Loss of theft	1,700
To Branch Creditors	10,400	By Sundry Branch Assets	1,71,110
	1,75,810		1,75,810

Profit and Loss Account for 2012

	₹		₹
To Loss by Theft	1,700	By Balance b/d	25,310
To Interim Dividend for Aug., 2012	30,000	By Year's Profit : H.O.	82,200
To Balance c/d	1,07,510	Branch	31,700
	1,39,210		1,39,210

Balance Sheet of the Company as on 31st Dec., 2012

Particulars	*Note No*	*Amount (₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	8,00,000
(b) Reserves and Surplus	2	2,07,510
(2) Current Liabilities		
Trade payables	3	32,300
Total		10,39,810
II. Assets		
(1) Non-current assets		
Fixed assets	4	6,25,000
(2) Current assets		
(a) Inventories	5	2,72,930
(b) Trade Receivables	6	69,600
(c) Cash and cash equivalents	7	72,280
Total		10,39,810

Notes to Accounts

			₹
1.	**Share Capital**		
	Authorised capital :		
	10,000 Equity Shares of ₹ 100 each		10,00,000
	Issued and Subscribed Capital :		
	8,000 Equity Shares of ₹ 100 each fully paid		8,00,000
2.	**Reserves and Surplus**		
	General Reserve	1,00,000	
	Profit & Loss Account	1,07,510	2,07,510
3.	**Trade payables**		
	Creditors		
	H.O.	21,900	
	Branch	10,400	32,300
4.	**Fixed Assets**		
	H.O.	5,30,000	
	Branch	95,000	6,25,000
5.	**Inventories**		
	H.O.	2,22,470	
	Branch	50,460	2,72,930
6.	**Trade Receivables**		
	H.O.	50,500	
	Branch	19,100	69,600
7.	**Cash and cash equivalents**		
	Cash in Hand :		
	H.O.	62,730	
	Branch	6,550	69,280
	Cash in Transit		3,000
			72,280

Illustration 15

KP manufactures a range of goods which it sells to wholesale customers only from its head office. In addition, the H.O. transfers goods to a newly opened branch at factory cost plus 15%. The branch then sells these goods to the general public on only cash basis.

The selling price to wholesale customers is designed to give a factory profit which amounts to 30% of the sales value. The selling price to the general public is designed to give a gross margin (i.e., selling price less cost of goods from H.O.) of 30% of the sales value.

KP operates from rented premises and leases all other types of fixed assets. The rent and hire charges for these are included in the overhead costs shown in the trial balances.

From the information given below, you are required to prepare for the year ended 31st Dec., 2012 in columnar form.

(a) A Profit & Loss account for (i) H.O. (ii) the branch (iii) the entire business.

(b) Balance Sheet as on 31st Dec., 2012 for the entire business.

	H.O.		Branch	
	₹	₹	₹	₹
Raw materials purchased	35,000			
Direct wages	1,08,500			
Factory overheads	39,000			
Stock on 1-1-2012				
Raw materials	1,800			
Finished goods	13,000		9,200	
Debtors	37,000			
Cash	22,000		1,000	
Administrative Salaries	13,900		4,000	
Salesmen's Salaries	22,500		6,200	
Other administrative & selling overheads	12,500		2,300	
Inter-unit accounts	5,000			2,000
Capital		50,000		
Sundry Creditors		13,000		
Provision for unrealized profit in stock		1,200		
Sales		2,00,000		65,200
Goods sent to Branch		46,000		
Goods received from H.O.			44,500	
	3,10,200	3,10,200	67,200	67,200

Notes:

(1) On 28th Dec., 2012 the branch remitted ₹ 1,500 to the H.O. and this has not yet been recorded in the H.O. books. Also on the same date, the H.O. dispatched goods to the branch invoiced at ₹ 1,500 and these too have not yet been entered into the branch books. It is the company's policy to adjust items in transit in the books of the recipient.

(2) The stock of raw materials held at the H.O. on 31st Dec., 2012 was valued at ₹ 2,300.

(3) You are advised that:

- *there were no stock losses incurred at the H.O. or at the branch.*
- *it is KP's practice to value finished goods stock at the H.O. at factory cost.*
- *there were no opening or closing stock of work-in-progress.*

(4) Branch employees are entitled to a bonus of ₹ 156 under a bilateral agreement.

Solution

In the books of KP

Trading and Profit & Loss Account for the year ended 31st Dec., 2012

	H.O. ₹	*Branch* ₹	*Total* ₹		*H.O.* ₹	*Branch* ₹	*Total* ₹
To Material consumed	34,500	-	34,500	By Sales	2,00,000	65,200	2,65,200
To Wages	1,08,500	-	1,08,500	By Goods Sent to Branch	46,000	-	-
To Factory Overheads	39,000	-	39,000				
To Opening stock of finished goods	13,000	9,200	22,200	By Closing stock	15,000	9,560	24,560
To Goods from H.O.		46,000					
To Gross Profit c/d	66,000	19,560	85,560				
	2,61,000	74,760	2,89,760		2,61,000	74,760	2,89,760
To Admn. Salaries	13,900	4,000	17,900	By Gross Profit b/d	66,000	19,560	85,560
To Salesmen Salaries	22,500	6,200	28,700				
To Other Admn. & Overheads	12,500	2,300	14,800				
To Stock Reserve (increase)	47	-	47				
To Bonus to Staff	-	156	156				
To Net Profit	17,053	6,904	23,957				
	66,000	19,560	85,560		66,000	19,560	85,560

Balance Sheet as on 31st Dec., 2012

			H.O.	Branch	Total		H.O.	Branch	Total
		₹	₹	₹	₹		₹	₹	₹
Capital			50,000	-	50,000	Fixed Assets	-	-	-
Profit :	H.O.	17,053				Current Assets:			
	Branch	6,904	23,957		23,957	Raw material	2,300		2,300
Trade Creditors			13,000		13,000	Finished Goods	15,000	9,560	23,313 *
Bonus Payable				156	156	(Less Stock Res.)			
H.O. Account				10,404		Debtors	37,000	-	37,000
Stock Reserve			1,247			Cash (including transit item)	23,500	1,000	24,500
						Branch A/c	10,404*		
			88,204	10,560	87,113		88,204	10,560	87,113

*9,560 × 100/115 *i.e.,* (8,313 + 15,000) = ₹ 23,313

** (5,000 + 6,904) – 1500 = ₹ 10,404.

9. Incomplete Information in Branch Books

If it is desired that profitability of the branch should be kept secret from the branch staff, the head office would hold back some key information from the branch, e.g., amount of opening stock, cost of goods sent to the branch, etc. The head office, in such a case would maintain a record of goods sent to the branch by passing the entry:

Goods Supplied to the Branch Account Dr.

To Purchases Account

The value of the closing stock will also be adjusted only in head office books.

In such a case, for closing its books at the end of the year, the branch will simply transfer various revenue accounts to the head office without drawing up a Trading and Profit & Loss Account.

On that basis, supplemented by the record of transactions maintained at the head office, it will be possible to construct the Trading and Profit & Loss Account of the branch.

Illustration 16

AFFIX of Kolkata has a branch at Delhi to which the goods are supplied from Kolkata but the cost thereof is not recorded in the Head Office books. On 31st March, 2012 the Branch Balance Sheet was as follows :

Liabilities	*₹*	*Assets*	*₹*
Creditors Balance	*40,000*	*Debtors Balance*	*2,00,000*
Head Office	*1,68,000*	*Building Extension A/c closed by transfer to H.O. A/c*	*---*
		Cash at Bank	*8,000*
	2,08,000		*2,08,000*

During the six months ending on 30-9-2012, the following transactions took place at Delhi.

	₹		*₹*
Sales	*2,40,000*	*Manager's Salary*	*4,800*
Purchases	*48,000*	*Collections from Debtors*	*1,60,000*
Wages paid	*20,000*	*Discounts allowed*	*8,000*
Salaries (inclusive of advance of ₹ 2,000)	*6,400*	*Discount earned*	*1,200*
		Cash paid to Creditors	*60,000*
General Expenses	*1,600*	*Building Account (further payment)*	*4,000*
Fire Insurance (paid for one year)	*3,200*	*Cash in Hand*	*1,600*
Remittance to H.O.	*38,400*	*Cash at Bank*	*28,000*

Set out the Head Office Account in Delhi books and the Branch Balance Sheet as on 30-9-2012. Also give journal entries in the Delhi books.

Solution

Journal Entries

2012 30 Sept.		Dr. ₹	Cr. ₹
Salary Advance A/c	Dr.	2,000	
To Salaries A/c			2,000
(The amount paid as advance adjusted by debit to Salary Advance Account)			
Prepared Insurance A/c	Dr.	1,600	
To Fire Insurance A/c			1,600
(Six months premium transferred to the Prepaid Insurance A/c)			
Head Office Account	Dr.	88,400	

To Purchases A/c			48,000
To Wages A/c			20,000
To Salaries A/c			4,400
To General Expenses A/c			1,600
To Fire Insurance A/c			1,600
To Manager's Salary A/c			4,800
To Discount Allowed A/c			8,000
(Transfer of various revenue accounts (Dr.) to the H.O. Account for closing the accounts)			
Sales Accounts	Dr.	2,40,000	
Discount Earned A/c	Dr.	1,200	
To Head Office A/c			2,41,200
[Revenue accounts (Cr.) transferred to H.O.]			
Head Office Account	Dr.	4,000	
To Building Account			4,000
(Transfer of amounts spent on building extension to H.O. A/c)			

Head Office Account

2012		₹	2012		₹
Sep. 30	To Cash-remittance	38,400	April 1	By Balance b/d	1,68,000
	To Sundries (Revenue A/cs)	88,400	Sep. 30	By Sundries	2,41,200
	To Building A/c	4,000		(Revenue A/cs)	
	To Balanced c/d	2,78,400			
		4,09,200			4,09,200

Balance Sheet of Delhi Branch as on Sept. 30, 2012

Liabilities	₹	*Assets*	₹
Creditors Balances	26,800	Debtors Balances	2,72,000
Head Office Account	2,78,400	Salary Advance	2,000
		Prepaid Insurance	1,600
		Building Extension A/c transferred to H.O.	—
		Cash in Hand	1,600
		Cash at Bank	28,000
	3,05,200		3,05,200

Cash and Bank Account

	₹		₹
To Balance b/d	8,000	By Wages	20,000

To Collection from Debtors	1,60,000	By Salaries			6,400
		By Insurance			3,200
		By General Exp.			1,600
		By H.O. A/c			38,400
		By Manager's Salary			4,800
		By Creditors			60,000
		By Building A/c			4,000
		By Balance c/d			
		By Cash in Hand		1,600	
		By Cash at Bank		28,000	29,600
	1,68,000				1,68,000

Debtors Account

	₹			₹
To Balance b/d	2,00,000	By	Cash Collection	1,60,000
To Sales	2,40,000	By	Discount (allowed)	8,000
		By	Balance c/d	2,72,000
	4,40,000			4,40,000
To Balance b/d	2,72,000			

Creditors Account

	₹		₹
To Cash	60,000	By Balance b/d	40,000
To Discount (earned)	1,200	By Purchases	48,000
To Balance c/d	26,800		
	88,000		88,000
		By Balance b/d	26,800

Illustration 17

The following Trial balances as at 31st December, 2012 have been extracted from the books of Major Ltd. and its branch at a stage where the only adjustments requiring to be made prior to the preparation of a Balance Sheet for the undertaking as a whole.

	Head Office		***Branch***	
	Dr. ₹	*Cr.* ₹	*Dr.* ₹	*Cr.* ₹
Share Capital		*1,50,000*		
Fixed Assets	*75,125*		*18,901*	
Current Assets	*1,21,809*		*23,715*	*(Note 3)*

Current Liabilities		*34,567*		*9,721*
Stock Reserve, 1st Jan., 2012				
(Note 2)		*693*		
Revenue Account		*43,210*		*10,250*
Branch Account	*31,536*			
Head Office Account				*22,645*
	2,28,470	*2,28,470*	*42,616*	*42,616*

Notes :

1. *Goods transferred from Head Office to the Branch are invoiced at cost plus 10% and both Revenue Accounts have been prepared on the basis of the prices charged.*
2. *Relating to the Head Office goods held by the Branch on 1st January, 2012.*
3. *Includes goods received from Head Office at invoice price ₹ 4,565.*
4. *Goods invoiced by Head Office to Branch at ₹ 3,641 were in transit at 31st December, 2012, as was also a remittance of ₹ 3,500 from the Branch.*
5. *At 31st December, 2012, the following transactions were reflected in the Head Office books but unrecorded in the Branch books.*

The purchase price of lorry, ₹ 2,500, which reached the Branch on December 25th; a sum received on December 30, 2012 from one of the Branch debtors, ₹ 750.

You are required:

(i) to record the foregoing in the appropriate ledger accounts in both sets of books;

(ii) to prepare a Balance Sheet as at 31st December, 2012 for the undertaking as a whole.

Solution:

H.O. Books

Branch Account

2012		₹	2012		₹
Dec. 31	To Balance b/d	31,536	Dec. 31	By Cash in transit	3,500
				By Balance b/d	28,036
		31,536			31,536

Cash in Transit Account

2012		₹	2012		₹
Dec. 31	To Branch A/c	3,500	Dec. 31	By Balance c/d	3,500

Stock Reserve Account

2012		₹	2012		₹
Dec. 31	To Balance c/d	746	Jan. 1	By Balance c/d	693
				By Revenue A/c	53
		746			746

Revenue Account

2012		₹	2012		₹
Dec. 31	To Stock Reserve	53	Dec. 31	By Balance c/d	43,210
	To Balance c/d	43,157			
		43,210			43,210

Branch Books
Head Office Account

2012		₹	2012		₹
Dec.31	To Current Assets	750	Dec. 31	By Balance b/d	22,645
	To (Debtors)			By Goods in transit	3,641
	Balance c/d	28,036		By Motor Vehicle	2,500
		28,786			28,786

Goods in Transit Account

2012		₹	2012		₹
Dec. 31	To Head Office	3,641	Dec. 31	By Balance c/d	3,641

Motor Vehicle Account

2012		₹	2012		₹
Dec. 31	To Head Office	2,500	Dec. 31	By Balance c/d	2,500

Sundry Current Assets A/c

2012		₹	2012		₹
Dec. 31	To Balance b/d	23,715	Dec. 31	By H.O. (Remittance by Debtor)	750
				By Balance c/d	22,965
		23,715			23,715

Balance Sheet of Major Ltd. as on 31st Dec., 2012

Particulars	*Note No*	*Amount (₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital		1,50,000

(2) Non-Current Liabilities		
Long-term borrowings	1	53,407
(3) Current Liabilities		44,288
Total		2,47,695
II. Assets		
(1) Non-current assets		
Fixed assets		96,526
(2) Current assets		1,51,169
Total		2,47,695

Notes to Accounts

		₹
	Long term borrowings Secured Loans	53,407

Working Notes:

		₹
(*i*) Fixed Assets:	Head Office	75,125
	Branch	18,901
	Motor Vehicle	2,500
		96,526
(*ii*) Current Assets :	Head Office	1,21,809
	Cash in transit	3,500
	Branch (23,715–750)	22,965
	Stock in transit	3,641
		1,51,915
	Less : Stock Reserve	(746)
		1,51,169
(*iii*) Revenue Account	Head Office (43,210 – 53)	43,157
	Branch	10,250
		53,407
(*iv*) Current Liabilities :	Head Office	34,567
	Branch	9,721
		44,288

10. Foreign Branches

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Thus problems of incorporating balances of foreign branches relate mainly to translation of foreign currency into Indian rupees. This is because exchange rate of Indian rupee is not stable in relation to foreign currencies due to international demand and supply effects on various currencies. The accounting principles which apply to inland branches also apply to a foreign branch after converting the trial balance of the foreign branch in the Indian currency.

11. Accounting for Foreign Branches

For the purpose of accounting, AS 11 (revised 2003) classifies the foreign branches may be classified into two types:

- Integral Foreign Operation;
- Non- Integral Foreign Operation.

Let us discuss these two types of foreign branches in detail.

11.1 Integral Foreign Operation (IFO): It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprise's operations. Generally, IFO carries on business in a single foreign currency, ie. of the country where it is located. For example, sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.

11.2 Non-Integral Foreign Operation (NFO): It is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency. An NFO may also enter into transactions in foreign currencies, including transactions in the reporting currency. An example of NFO may be production in a foreign currency out of the resources available in such country independent of the reporting enterprise.

The following are the indicators of Non- Integral Foreign Operation-

- *Control by reporting enterprises* - While the reporting enterprise may control the foreign operation, the activities of foreign operation are carried independently without much dependence on reporting enterprise.
- Transactions with the reporting enterprises are not a high proportion of the foreign operation's activities.
- Activities of foreign operation are mainly financed by its operations or from local borrowings. In other words it raises finance independently and is in no way dependent on reporting enterprises.
- Foreign operation sales are mainly in currencies other than reporting currency.
- All the expenses by foreign operations are primarily paid in local currency, not in the reporting currency.
- Day-to-day cash flow of the reporting enterprises is independent of the foreign enterprises cash flows.

- Sales prices of the foreign enterprises are not affected by the day-to-day changes in exchange rate of the reporting currency of the foreign operation.
- There is an active sales market for the foreign operation product.

The above are only indicators and not decisive/conclusive factors to classify the foreign operations as non-integral, much will depend on factual information, situations of the particular case and, therefore, judgment is necessary to determine the appropriate classification.

Controversies may arise in deciding the foreign branches of the enterprises into integral or non-integral. However, there may not be any controversy that subsidiary associates and joint ventures are non-integral foreign operation.

In case of branches classified as independent for the purpose of accounting are generally classified as non-integral foreign operations.

12. Change in Classification

When there is a change in classification, accounting treatment is as under-

12.1 Integral to Non-Integral

(i) Translation procedure applicable to non-integral shall be followed from the date of change.

(ii) Exchange difference arising on the translation of non-monetary assets at the date of re-classification is accumulated in foreign currency translation reserve.

12.2 Non-Integral to Integral

(i) Translation procedure as applicable to integral should be applied from the date of change.

(ii) Translated amount of non-monetary items at the date of change is treated as historical cost.

(iii) Exchange difference lying in foreign currency translation reserve is not to be recognized as income or expense till the disposal of the operation even if the foreign operation becomes integral.

13. Techniques for Foreign Currency Translation

13.1 Integral Foreign Operation (IFO): Following are the standard recommendations for foreign currency translation:

(1) All transactions of IFO be translated at the rate prevailing on the date of transaction. This will require date wise details of the transaction entered by that operation together with the rates. Weekly or monthly average rate is permitted if there are no significant variations in the rate.

(2) Translation at the balance sheet date-

(i) Monetary items[1] at closing rate;

(ii) Non-monetary items[2]: The cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If tangible fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation.

(iii) The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.

(iv) Exchange difference arising on the translation of the financial statement of integral foreign operation should be charged to profit and loss account.

13.2 Non-Integral Foreign Operation: Accounts of non-integral foreign operation are translated using the following principles:

- Balance sheet items i.e. Assets and Liabilities both monetary and non-monetary – apply closing exchange rate.
- Items of income and expenses – At actual exchange rates on the date of transactions. However, accounting standard allows average rate subject to materiality.
- Resulting exchange rate difference should be accumulated in a "foreign currency translation reserve" until the disposal of "net investment in non-integral foreign operation".

Illustration 18

On 31st December, 2012 the following balances appeared in the books of Chennai Branch of an English firm having its HO office in New York:

	Amount in ₹	*Amount in ₹*
Stock on 1st Jan., 2012	*2,34,000*	
Purchases and Sales	*15,62,500*	*23,43,750*
Debtors and Creditors	*7,65,000*	*5,10,000*
Bills Receivable and Payable	*2,04,000*	*1,78,500*
Salaries and Wages	*1,00,000*	-
Rent, Rates and Taxes	*1,06,250*	-
Furniture	*91,000*	-
Bank A/c	*5,68,650*	

[1] Monetary items are money held and assets and liabilities to be received or paid in fixed or determinable amounts of money. Cash, receivables and payables are examples of monetary items.

[2] Non-monetary items are assets and liabilities other than monetary items. Fixed assets, investments in equity shares, inventories are examples of non-monetary assets.

New York Account	*-*	*5,99,150*
	36,31,400	*36,31,400*

Stock on 31st December, 2012 was ₹ 6,37,500.

Branch account in New York books showed a debit balance of $ 13,400 on 31st December, 2012 and Furniture appeared in the Head Office books at $ 1,750.

The rate of exchange for 1 $ on 31st December, 2011 was ₹ 52 and on 31st December, 2012 was

₹ 51. The average rate for the year was ₹ 50.

Prepare in the Head Office books the Profit and Loss a/c and the Balance Sheet of the Branch.

Solution

In the books of English Firm (Head Office in New York)

Chennai Branch Profit and Loss Account

for the year ended 31st December, 2012

	$		$
To Opening stock	4,500	By Sales	46,875
To Purchases	31,250	By Closing stock	12,500
To Gross profit c/d	23,625	(6,37,500 / 51)	
	59,375		59,375
To Salaries	2,000	By Gross profit b/d	23,625
To Rent, rates and taxes	2,125		
To Exchange translation loss	2,000		
To Net Profit c/d	17,500		
	23,625		23,625

Balance Sheet of Chennai Branch

as on 31st December, 2012

Liabilities	$	$	Assets	$
Head Office A/c	13,400		Furniture	1,750
Add : Net profit	17,500	30,900	Closing Stock	12,500
Trade creditors		10,000	Trade Debtors	15,000
Bills Payable		3,500	Bills Receivable	4,000
			Cash at bank	11,150
		44,400		44,400

Working Note:

Calculation of Exchange Translation Loss

Chennai Branch Trial Balance (converted in $)

as on 31st December, 2012

	Dr.	Cr.	Conversion	Dr.	Cr.
	₹	₹	Rate	($)	($)
Stock on 1st Jan., 2012	2,34,000		52	4,500	
Purchases & Sales	15,62,500	23,43,750	50	31,250	46,875
Debtors & creditors	7,65,000	5,10,000	51	15,000	10,000
Bills Receivable and Bills Payable	2,04,000	1,78,500	51	4,000	3,500
Salaries and wages	1,00,000		50	2,000	
Rent, Rates and Taxes	1,06,250		50	2,125	
Furniture	91,000			1,750	
Bank A/c	5,68,650		51	11,150	
New York Account		5,99,150			13,400
Exchange translation loss (bal. fig.)				2,000	
	36,31,400	36,31,400		73,775	73,775

Illustration 19

S & M Ltd., Bombay, have a branch in Sydney, Australia. Sydney branch is an integral foreign operation of S & M Ltd.

At the end of 31st March, 2013, the following ledger balances have been extracted from the books of the Bombay Office and the Sydney Office:

	Bombay		Sydney	
	(₹ thousands)		(Austr dollars thousands)	
	Debit	Credit	Debit	Credit
Share Capital	–	2,000	–	–
Reserves & Surplus	–	1,000	–	–
Land	500	–	–	–
Buildings (Cost)	1,000	–	–	–
Buildings Dep. Reserve	–	200	–	–
Plant & Machinery (Cost)	2,500	–	200	–
Plant & Machinery Dep. Reserve	–	600	–	130
Debtors / Creditors	280	200	60	30
Stock (1.4.2012)	100	–	20	–

Branch Stock Reserve	–	4	–	–
Cash & Bank Balances	10	–	10	–
Purchases / Sales	240	520	20	123
Goods sent to Branch	–	100	5	–
Managing Director's salary	30	–	–	–
Wages & Salaries	75	–	45	–
Rent	–	–	12	–
Office Expenses	25	–	18	–
Commission Receipts	–	256	–	100
Branch / H.O. Current A/c	120	–	–	7
	4,880	4,880	390	390

The following information is also available:

(1) Stock as at 31.3.2013:

Bombay ₹ 1,50,000

Sydney A $ 3,125

You are required to convert the Sydney Branch Trial Balance into rupees;

(use the following rates of exchange :

Opening rate	*A $ = ₹ 20*
Closing rate	*A $ = ₹ 24*
Average rate	*A $ = ₹ 22*
For Fixed Assets	*A $ = ₹ 18).*

Solution

Sydney Branch Trial Balance (in Rupees)
As on 31st March, 2013

(₹ '000)

Conversion	*rate per A$*	*Dr.*	*Cr.*
Plant & Machinery (cost)	₹ 18	36,00	
Plant & Machinery Dep. Reserve	₹ 18		23,40
Debtors / Creditors	₹ 24	14,40	7,20
Stock (1.4.2012)	₹ 20	4,00	
Cash & Bank Balances	₹ 24	2,40	
Purchase / Sales	₹ 22	4,40	27,06
Goods received from H.O.	–	1,00	
Wages & Salaries	₹ 22	9,90	
Rent	₹ 22	2,64	

Office expenses	₹ 22	3,96	
Commission Receipts	₹ 22		22,00
H.O. Current A/c			1,20
		78,70	80,86
Exchange loss (balancing figure)		2,16	
		80,86	80,86

Illustration 20

M/s Carlin has head office at New York (U.S.A.) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of Carlin & Co.

Mumbai branch furnishes you with its trial balance as on 31st March, 2013 and the additional information given thereafter:

	Dr.	*Cr.*
	Rupees in thousands	
Stock on 1st April, 2012	*300*	–
Purchases and sales	*800*	*1,200*
Sundry Debtors and creditors	*400*	*300*
Bills of exchange	*120*	*240*
Wages and salaries	*560*	–
Rent, rates and taxes	*360*	–
Sundry charges	*160*	–
Computers	*240*	
Bank balance	*420*	–
New York office a/c	–	*1,620*
	3,360	*3,360*

Additional information:

(a) *Computers were acquired from a remittance of US $ 6,000 received from New York head office and paid to the suppliers. Depreciate computers at 60% for the year.*

(b) *Unsold stock of Mumbai branch was worth ₹ 4,20,000 on 31st March, 2013.*

(c) *The rates of exchange may be taken as follows:*

- *on 1.4.2012 @ ₹ 40 per US $*
- *on 31.3.2013 @ ₹ 42 per US $*
- *average exchange rate for the year @ ₹ 41 per US $*
- *conversion in $ shall be made upto two decimal accuracy.*

You are asked to prepare in US dollars the revenue statement for the year ended 31st March, 2013 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York head office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $ 39609.18 on 31.3.2013 in New York books and there were no items pending reconciliation.

Solution

M/s Carlin
Mumbai Branch Trial Balance in (US $)
as on 31st March, 2013

	Conversion rate per US $ (₹)	*Dr.* US $	*Cr.* US $
Stock on 1.4.12	40	7,500.00	–
Purchases and sales	41	19,512.20	29,268.29
Sundry debtors and creditors	42	9,523.81	7,142.86
Bills of exchange	42	2,857.14	5,714.29
Wages and salaries	41	13,658.54	–
Rent, rates and taxes	41	8,780.49	–
Sundry charges	41	3,902.44	–
Computers	–	6,000.00	–
Bank balance	42	10,000.00	–
New York office A/c	–	–	39,609.18
		81,734.62	81,734.62

Trading and Profit & Loss Account
for the year ended 31st March, 2013

	US $		*US $*
To Opening Stock	7,500.00	By Sales	29,268.29
To Purchases	19,512.20	By Closing stock	10,000.00
To Wages and salaries	13,658.54	By Gross Loss c/d	1,402.45
	40,670.74		40,670.74
To Gross Loss b/d	1,402.45	By Net Loss	17,685.38
To Rent, rates and taxes	8,780.49		
To Sundry charges	3,902.44		

To Depreciation on computers (US $ 6,000 × 0.6)	3,600.00		
	17,685.38		17,685.38

Balance Sheet of Mumbai Branch as on 31st March, 2013

Liabilities		*US $*	*Assets*	*US $*	*US $*
New York Office A/c	39,609.18		Computers	6,000.00	
Less : Net Loss	(17,685.38)	21,923.80	*Less:* Depreciation	(3,600.00)	2,400.00
Sundry creditors		7,142.86	Closing stock		10,000.00
Bills payable		5,714.29	Sundry debtors		9,523.81
			Bank balance		10,000.00
			Bills receivable		2,857.14
		34,780.95			34,780.95

Summary

- **Types of branches**
  - ✓ Dependent branches
  - ✓ Independent branches
- **Classification of Branches from accounting point of view**
  - ✓ Branches in respect of which the whole of the accounting records are kept at the head office (Dependent Branches)
  - ✓ Branches which maintain independent accounting records (Independent Branches), and
  - ✓ Foreign Branches.
- **Systems of accounting followed by Dependent Branches**
  - ✓ Debtors System: under this system head office makes a branch account. Anything given to branch is debited and anything received from branch would be credited.
  - ✓ Branch trading and profit and loss account (Final accounts) method /branch account method: Under this system head office prepares (a) profit and loss account (b) branch account taking each branch as a separate entity.
  - ✓ Stock and debtors system: Under this system head office opens:

- **Branch Stock Account**
- **Branch Profit and Loss Account**
- **Branch Debtors Account**
- **Branch Expenses Account**
- **Goods sent to Branch Account**
- **Branch Asset Account**

- **Maintenance of comprehensive account books by Independent Branches** Preparation of separate trial balance of each branch in H.O.books.
- **Types of Foreign branches**
  - ✓ Integral Foreign Operation (IFO): It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.
  - ✓ Non-Integral Foreign Operation (NFO): It is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency.
- **Non-Integral Foreign Operation -translation**
  - ✓ Balance sheet items i.e. Assets and Liabilities both monetary and non-monetary – apply closing exchange rate.
  - ✓ Items of income and expenses – At actual exchange rates on the date of transactions
  - ✓ Resulting exchange rate difference should be accumulated in a "foreign currency translation reserve" until the disposal of "net investment in non-integral foreign operation".
- **Integral Foreign Operation (IFO) - translation**
  - ✓ at the rate prevailing on the date of transaction
- **Translation at the balance sheet date-**
  - ✓ Monetary items at closing rate;
  - ✓ Non-monetary items: The cost and depreciation of the tangible fixed assets is translated using the exchange rate at the date of purchase of the asset if asset is carried at cost. If tangible fixed asset is carried at fair value, translation should be done using the rate existed on the date of the valuation.
  - ✓ The cost of inventories is translated at the exchange rates that existed when the cost of inventory was incurred and realizable value is translated applying exchange rate when realizable value is determined which is generally closing rate.
  - ✓ Exchange difference arising on the translation of the financial statement of integral foreign operation should be charged to profit and loss account.

APPENDIX

SCHEDULE III

(See section 129)

General Instructions for preparation of Balance Sheet and Statement of Profit and Loss of A Company

General Instructions

1. Where compliance with the requirements of the Act including Accounting Standards as applicable to the companies require any change in treatment or disclosure including addition, amendment, substitution or deletion in the head/sub-head or any changes *inter se*, in the financial statements or statements forming part thereof, the same shall be made and the requirements of this Schedule shall stand modified accordingly.

2. The disclosure requirements specified in this Schedule are in addition to and not in substitution of the disclosure requirements specified in the Accounting Standards prescribed under the Companies Act, 2013. Additional disclosures specified in the Accounting Standards shall be made in the notes to accounts or by way of additional statement unless required to be disclosed on the face of the Financial Statements. Similarly, all other disclosures as required by the Companies Act shall be made in the notes to accounts in addition to the requirements set out in this Schedule.

3. (i) Notes to accounts shall contain information in addition to that presented in the Financial Statements and shall provide where required (a) narrative descriptions or disaggregations of items recognized in those statements and (b) information about items that do not qualify for recognition in those statements.

   (ii) Each item on the face of the Balance Sheet and Statement of Profit and Loss shall be cross-referenced to any related information in the notes to accounts. In preparing the Financial Statements including the notes to accounts, a balance shall be maintained between providing excessive detail that may not assist users of financial statements and not providing important information as a result of too much aggregation.

4. (i) Depending upon the turnover of the company, the figures appearing in the Financial Statements may be rounded off as given below:

Turnover	Rounding off
(a) less than one hundred crore rupees	to the nearest hundreds, thousands, lakhs or millions, or decimals thereof
(b) one hundred crore rupees or more	to the nearest, lakhs, millions or crores, or decimals thereof.

   (ii) Once a unit of measurement is used, it shall be used uniformly in the Financial Statements.

5. Except in the case of the first Financial Statements laid before the Company (after its incorporation) the corresponding amounts (comparatives) for the immediately preceding reporting period for all items shown in the Financial Statements including notes shall also be given.

6. For the purpose of this Schedule, the terms used herein shall be as per the applicable Accounting Standards.

Note: This part of Schedule sets out the minimum requirements for disclosure on the face of the Balance Sheet, and the Statement of Profit and Loss (hereinafter referred to as "Financial Statements" for the purpose of this Schedule) and Notes. Line items, sub-line items and sub-totals shall be presented as an addition or substitution on the face of the Financial Statements when such presentation is relevant to an understanding of the company's financial position or performance or to cater to industry/sector-specific disclosure requirements or when required for compliance with the amendments to the Companies Act or under the Accounting Standards.

PART I – BALANCE SHEET

Name of the Company……………………..

Balance Sheet as at ………………………

(Rupees in…………)

			Particulars	*Note No.*	*Figures as at the end of current reporting period*	*Figures as at the end of previous reporting period*
			1	*2*	*3*	*4*
			EQUITY AND LIABILITIES			
1.			**Shareholders' funds**			
	a		Share capital			
	b		Reserves and Surplus			
	c		Money received against share warrants			
2.			**Share application money pending allotment**			
3.			**Non-current liabilities**			
	a		Long-term borrowings			
	b		Deferred tax liabilities (Net)			
	c		Other long term liabilities			
	d		Long-term provisions			

4.			**Current liabilities**			
	a		Short-term borrowings			
	b		Trade Payables			
	c		Other current liabilities			
	d		Short-term provisions			
			Total			
			ASSETS			
1			**Non-current assets**			
	a		Fixed assets			
		i	Tangible assets			
		ii	Intangible assets			
		iii	Capital Work-in-progress			
		iv	Intangible assets under development			
	b		Non-current investments			
	c		Deferred tax assets (Net)			
	d		Long-term loans and advances			
	e		Other non-current assets			
2			**Current assets**			
	a		Current investments			
	b		Inventories			
	c		Trade receivables			
	d		Cash and cash equivalents			
	e		Short-term loans and advances			
	f		Other current assets			
			Total			

See accompanying notes to Financial Statements.

Notes

GENERAL INSTRUCTIONS FOR PREPARATION OF BALANCE SHEET

1. An asset shall be classified as current when it satisfies any of the following criteria:

   (a) it is expected to be realized in, or is intended for sale or consumption in, the company's normal operating cycle;

   (b) it is held primarily for the purpose of being traded;

(c) it is expected to be realized within twelve months after the reporting date; or

(d) it is cash or cash equivalent unless it is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting date.

All other assets shall be classified as non-current.

2. An operating cycle is the time between the acquisition of assets for processing and their realization in cash or cash equivalents. Where the normal operating cycle cannot be identified, it is assumed to have a duration of 12 months.

3. A liability shall be classified as current when it satisfies any of the following criteria:

(a) it is expected to be settled in the company's normal operating cycle;

(b) it is held primarily for the purpose of being traded;

(c) it is due to be settled within twelve months after the reporting date; or

(d) the company does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date. Terms of a liability that could, at the option of the counterparty, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities shall be classified as non-current.

4. A receivable shall be classified as a 'trade receivable' if it is in respect of the amount due on account of goods sold or services rendered in the normal course of business.

5. A payable shall be classified as a 'trade payable' if it is in respect of the amount due on account of goods purchased or services received in the normal course of business.

6. A company shall disclose the following in the notes to accounts:

A. Share Capital

For each class of share capital (different classes of preference shares to be treated separately):

(a) the number and amount of shares authorized;

(b) the number of shares issued, subscribed and fully paid, and subscribed but not fully paid;

(c) par value per share;

(d) a reconciliation of the number of shares outstanding at the beginning and at the end of the reporting period;

(e) the rights, preferences and restrictions attaching to each class of shares including restrictions on the distribution of dividends and the repayment of capital;

(f) shares in respect of each class in the company held by its holding company or its ultimate holding company including shares held by or by subsidiaries or associates of the holding company or the ultimate holding company in aggregate;

(g) shares in the company held by each shareholder holding more than 5 percent shares specifying the number of shares held;

(h) shares reserved for issue under options and contracts/commitments for the sale of shares/disinvestment, including the terms and amounts;

(i) for the period of five years immediately preceding the date as at which the Balance Sheet is prepared:

(A) Aggregate number and class of shares allotted as fully paid up pursuant to contract(s) without payment being received in cash.

(B) Aggregate number and class of shares allotted as fully paid up by way of bonus shares.

(C) Aggregate number and class of shares bought back.

(j) terms of any securities convertible into equity/preference shares issued along with the earliest date of conversion in descending order starting from the farthest such date.

(k) calls unpaid (showing aggregate value of calls unpaid by directors and officers)

(l) forfeited shares (amount originally paid up)

B. Reserves and Surplus

(i) Reserves and Surplus shall be classified as:

(a) Capital Reserves;

(b) Capital Redemption Reserve;

(c) Securities Premium Reserve;

(d) Debenture Redemption Reserve;

(e) Revaluation Reserve;

(f) Share Options Outstanding Account;

(g) Other Reserves – (specify the nature and purpose of each reserve and the amount in respect thereof);

(h) Surplus i.e. balance in Statement of Profit & Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc.

(Additions and deductions since last balance sheet to be shown under each of the specified heads)

(ii) A reserve specifically represented by earmarked investments shall be termed as a 'fund'.

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'. Similarly, the balance of 'Reserves and Surplus', after adjusting negative balance of surplus, if any, shall be shown under the head 'Reserves and Surplus' even if the resulting figure is in the negative.

C. Long-Term Borrowings

(i) Long-term borrowings shall be classified as:

(a) Bonds/debentures.

(b) Term loans

(A) From banks.

(B) From other parties

(c) Deferred payment liabilities.

(d) Deposits.

(e) Loans and advances from related parties.

(f) Long term maturities of finance lease obligations

(g) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Bonds/debentures (along with the rate of interest and particulars of redemption or conversion, as the case may be) shall be stated in descending order of maturity or conversion, starting from farthest redemption or conversion date, as the case may be. Where bonds/debentures are redeemable by instalments, the date of maturity for this purpose must be reckoned as the date on which the first instalment becomes due.

(v) Particulars of any redeemed bonds/ debentures which the company has power to reissue shall be disclosed.

(vi) Terms of repayment of term loans and other loans shall be stated.

(vii) Period and amount of continuing default as on the balance sheet date in repayment of loans and interest, shall be specified separately in each case.

D. Other Long Term Liabilities

Other Long term Liabilities shall be classified as:

(a) Trade payables

(b) Others

E. Long-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

F. Short-term borrowings

(i) Short-term borrowings shall be classified as:

(a) Loans repayable on demand

(A) From banks

(B) From other parties

(b) Loans and advances from related parties.

(c) Deposits.

(d) Other loans and advances (specify nature).

(ii) Borrowings shall further be sub-classified as secured and unsecured. Nature of security shall be specified separately in each case.

(iii) Where loans have been guaranteed by directors or others, the aggregate amount of such loans under each head shall be disclosed.

(iv) Period and amount of default as on the balance sheet date in repayment of loans and interest shall be specified separately in each case.

G. Other current liabilities

The amounts shall be classified as:

(a) Current maturities of long-term debt;

(b) Current maturities of finance lease obligations;

(c) Interest accrued but not due on borrowings;

(d) Interest accrued and due on borrowings;

(e) Income received in advance;

(f) Unpaid dividends

(g) Application money received for allotment of securities and due for refund and interest accrued thereon. Share application money includes advances towards allotment of share capital. The terms and conditions including the number of shares proposed to be issued, the amount of premium, if any, and the period before which shares shall be allotted shall be disclosed. It shall also be disclosed whether the company has sufficient authorized capital to cover the share capital amount resulting from allotment of shares out of such share application money. Further, the period for which the share application money has been pending beyond the period for allotment as mentioned in the document inviting application for shares along with the reason for such share application money being pending shall be disclosed. Share application money not exceeding the issued capital and to the extent not refundable shall be shown under the head Equity and share application money to the extent refundable i.e., the amount in excess of subscription or in case the requirements of minimum subscription are not met, shall be separately shown under 'Other current liabilities'

(h) Unpaid matured deposits and interest accrued thereon

(i) Unpaid matured debentures and interest accrued thereon

(j) Other payables (specify nature);

H. Short-term provisions

The amounts shall be classified as:

(a) Provision for employee benefits.

(b) Others (specify nature).

I. Tangible assets

(i) Classification shall be given as:

(a) Land.

(b) Buildings.

(c) Plant and Equipment.

(d) Furniture and Fixtures.

(e) Vehicles.

(f) Office equipment.

(g) Others (specify nature).

(ii) Assets under lease shall be separately specified under each class of asset.

(iii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related depreciation and impairment losses/reversals shall be disclosed separately.

(iv) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

J. Intangible assets

(i) Classification shall be given as:

(a) Goodwill.

(b) Brands /trademarks.

(c) Computer software.

(d) Mastheads and publishing titles.

(e) Mining rights.

(f) Copyrights, and patents and other intellectual property rights, services and operating rights.

(g) Recipes, formulae, models, designs and prototypes.

(h) Licenses and franchise.

(i) Others (specify nature).

(ii) A reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations and other adjustments and the related amortization and impairment losses/reversals shall be disclosed separately.

(iii) Where sums have been written off on a reduction of capital or revaluation of assets or where sums have been added on revaluation of assets, every balance sheet subsequent to date of such write-off, or addition shall show the reduced or increased figures as applicable and shall by way of a note also show the amount of the reduction or increase as applicable together with the date thereof for the first five years subsequent to the date of such reduction or increase.

K. Non-current investments

(i) Non-current investments shall be classified as trade investments and other investments and further classified as:

(a) Investment property;

(b) Investments in Equity Instruments;

(c) Investments in preference shares

(d) Investments in Government or trust securities;

(e) Investments in debentures or bonds;

(f) Investments in Mutual Funds;

(g) Investments in partnership firms

(h) Other non-current investments (specify nature)

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) Investments carried at other than at cost should be separately stated specifying the basis for valuation thereof.

(iii) The following shall also be disclosed:

(a) Aggregate amount of quoted investments and market value thereof;

(b) Aggregate amount of unquoted investments;

(c) Aggregate provision for diminution in value of investments.

L. Long-term loans and advances

(i) Long-term loans and advances shall be classified as:

(a) Capital Advances;

(b) Security Deposits;

(c) Loans and advances to related parties (giving details thereof);

(d) Other loans and advances (specify nature).

(ii) The above shall also be separately sub-classified as:

(a) Secured, considered good;

(b) Unsecured, considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other persons or amounts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

M. Other non-current assets

Other non-current assets shall be classified as:

(i) Long Term Trade Receivables (including trade receivables on deferred credit terms);

(ii) Others (specify nature)

(iii) Long term Trade Receivables, shall be sub-classified as:

(a) (A) Secured, considered good;

(B) Unsecured considered good;

(C) Doubtful

(b) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(c) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

N. Current Investments

(i) Current investments shall be classified as:

(a) Investments in Equity Instruments;

(b) Investment in Preference Shares

(c) Investments in government or trust securities;

(d) Investments in debentures or bonds;

(e) Investments in Mutual Funds;

(f) Investments in partnership firms

(g) Other investments (specify nature).

Under each classification, details shall be given of names of the bodies corporate [indicating separately whether such bodies are (i) subsidiaries, (ii) associates, (iii) joint ventures, or (iv) controlled special purpose entities] in whom investments have been made and the nature and extent of the investment so made in each such body corporate (showing separately investments which are partly-paid). In regard to investments in the capital of partnership firms, the names of the firms (with the names of all their partners, total capital and the shares of each partner) shall be given.

(ii) The following shall also be disclosed:

(a) The basis of valuation of individual investments

(b) Aggregate amount of quoted investments and market value thereof;

(c) Aggregate amount of unquoted investments;

(d) Aggregate provision made for diminution in value of investments.

O. Inventories

(i) Inventories shall be classified as:

(a) Raw materials;

(b) Work-in-progress;

(c) Finished goods;

(d) Stock-in-trade (in respect of goods acquired for trading);

(e) Stores and spares;

(f) Loose tools;

(g) Others (specify nature).

(ii) Goods-in-transit shall be disclosed under the relevant sub-head of inventories.

(iii) Mode of valuation shall be stated.

P. Trade Receivables

(i) Aggregate amount of Trade Receivables outstanding for a period exceeding six months from the Date they are due for payment should be separately stated.

(ii) Trade receivables shall be sub-classified as:

(a) Secured, considered good;

(b) Unsecured considered good;

(c) Doubtful.

(iii) Allowance for bad and doubtful debts shall be disclosed under the relevant heads separately.

(iv) Debts due by directors or other officers of the company or any of them either severally or jointly with any other person or debts due by firms or private companies respectively in which any director is a partner or a director or a member should be separately stated.

Q. Cash and cash equivalents

(i) Cash and cash equivalents shall be classified as:

(a) Balances with banks;

(b) Cheques, drafts on hand;

(c) Cash on hand;

(d) Others (specify nature).

(ii) Earmarked balances with banks (for example, for unpaid dividend) shall be separately stated.

(iii) Balances with banks to the extent held as margin money or security against the borrowings, guarantees, other commitments shall be disclosed separately.

(iv) Repatriation restrictions, if any, in respect of cash and bank balances shall be separately stated.

(v) Bank deposits with more than 12 months maturity shall be disclosed separately.

R. Short-term loans and advances

(i) Short-term loans and advances shall be classified as:

(a) Loans and advances to related parties (giving details thereof);

(b) Others (specify nature).

(ii) The above shall also be sub-classified as:

  (a) Secured, considered good;

  (b) Unsecured, considered good;

  (c) Doubtful.

(iii) Allowance for bad and doubtful loans and advances shall be disclosed under the relevant heads separately.

(iv) Loans and advances due by directors or other officers of the company or any of them either severally or jointly with any other person or amounts due by firms or private companies respectively in which any director is a partner or a director or a member shall be separately stated.

S. Other current assets (specify nature).

This is an all-inclusive heading, which incorporates current assets that do not fit into any other asset categories.

T. Contingent liabilities and commitments (to the extent not provided for)

(i) Contingent liabilities shall be classified as:

  (a) Claims against the company not acknowledged as debt;

  (b) Guarantees;

  (c) Other money for which the company is contingently liable

(ii) Commitments shall be classified as:

  (a) Estimated amount of contracts remaining to be executed on capital account and not provided for;

  (b) Uncalled liability on shares and other investments partly paid

  (c) Other commitments (specify nature).

U. The amount of dividends proposed to be distributed to equity and preference shareholders for the period and the related amount per share shall be disclosed separately. Arrears of fixed cumulative dividends on preference shares shall also be disclosed separately.

V. Where in respect of an issue of securities made for a specific purpose, the whole or part of the amount has not been used for the specific purpose at the balance sheet date, there shall be indicated by way of note how such unutilized amounts have been used or invested.

W. If, in the opinion of the Board, any of the assets other than fixed assets and non-current investments do not have a value on realization in the ordinary course of business at least equal to the amount at which they are stated, the fact that the Board is of that opinion, shall be stated.

PART II – STATEMENT OF PROFIT AND LOSS

Name of the Company…………………….

Profit and loss statement for the year ended ………………………

(Rupees in…………)

Particulars		*Note No.*	*Figures for the current reporting period*		*Figures for the previous reporting period*	
1		*2*	*3*		*4*	
I.	Revenue from operations			xxx		xxx
II.	Other income			xxx		xxx
III.	Total Revenue (I + II)			xxx		xxx
IV.	Expenses:			xxx		xxx
	Cost of materials consumed			xxx		xxx
	Purchases of Stock-in-Trade			xxx		xxx
	Changes in inventories of finished goods			xxx		xxx
	work-in-progress			xxx		xxx
	and Stock-in-Trade			xxx		xxx
	Employee benefits expense			xxx		xxx
	Finance costs			xxx		xxx
	Depreciation and amortization expense			xxx		xxx
	Other expenses			xxx		xxx
	Total expenses			xxx		xxx
V.	Profit before exceptional and extraordinary items and tax (III-IV)			xxx		xxx
VI.	Exceptional items			xxx		xxx
VII.	Profit before extraordinary items and tax (V - VI)			xxx		xxx
VIII.	Extraordinary Items			xxx		xxx
IX.	Profit before tax (VII- VIII)			xxx		xxx
X	Tax expense:					
	(1) Current tax		xxx		xxx	
	(2) Deferred tax		xxx	xxx	xxx	xxx
XI	Profit (Loss) for the period from continuing operations (VII-VIII)			xxx		Xxx
XII	Profit/(loss) from discontinuing operations			xxx		Xxx

XIII	Tax expense of discontinuing operations		xxx	Xxx
XIV	Profit/(loss) from Discontinuing operations (after tax) (XII-XIII)		xxx	Xxx
XV	Profit (Loss) for the period (XI + XIV)		xxx	xxx
XVI	Earnings per equity share:			
	(1) Basic		xxx	xxx
	(2) Diluted		xxx	xxx

See accompanying notes to the financial statements.

GENERAL INSTRUCTIONS FOR PREPARATION OF STATEMENT OF PROFIT AND LOSS

1. The provisions of this Part shall apply to the income and expenditure account referred to in sub-clause (ii) of Clause (40) of Section 2 in like manner as they apply to a statement of profit and loss.

2. (A) In respect of a company other than a finance company revenue from operations shall disclose separately in the notes revenue from

(a) Sale of products;

(b) Sale of services;

(c) Other operating revenues;

Less:

(d) Excise duty.

(B) In respect of a finance company, revenue from operations shall include revenue from

(a) Interest; and

(b) Other financial services

Revenue under each of the above heads shall be disclosed separately by way of notes to accounts to the extent applicable.

3. Finance Costs

Finance costs shall be classified as:

(a) Interest expense;

(b) Other borrowing costs;

(c) Applicable net gain/loss on foreign currency transactions and translation.

4. Other income

Other income shall be classified as:

(a) Interest Income (in case of a company other than a finance company);

(b) Dividend Income;

(c) Net gain/loss on sale of investments

(d) Other non-operating income (net of expenses directly attributable to such income).

5. Additional Information

A Company shall disclose by way of notes additional information regarding aggregate expenditure and income on the following items:-

(i) (a) Employee Benefits Expense [showing separately (i) salaries and wages, (ii) contribution to provident and other funds, (iii) expense on Employee Stock Option Scheme (ESOP) and Employee Stock Purchase Plan (ESPP), (iv) staff welfare expenses].

(b) Depreciation and amortization expense;

(c) Any item of income or expenditure which exceeds one per cent of the revenue from operations or ₹ 1,00,000, whichever is higher;

(d) Interest Income;

(e) Interest Expense;

(f) Dividend Income;

(g) Net gain/ loss on sale of investments;

(h) Adjustments to the carrying amount of investments;

(i) Net gain or loss on foreign currency transaction and translation (other than considered as finance cost);

(j) Payments to the auditor as

(a) auditor,

(b) for taxation matters,

(c) for company law matters,

(d) for management services,

(e) for other services,

(f) for reimbursement of expenses;

(k) In case of companies covered u/s 135, amount of expenditure incurred on corporate social responsibility activities.

(l) Details of items of exceptional and extraordinary nature;

(m) Prior period items;

(ii) (a) In the case of manufacturing companies,-

(1) Raw materials under broad heads.

(2) goods purchased under broad heads.

(b) In the case of trading companies, purchases in respect of goods traded in by the company under broad heads.

(c) In the case of companies rendering or supplying services, gross income derived from services rendered or supplied under broad heads.

(d) In the case of a company, which falls under more than one of the categories mentioned in (a), (b) and (c) above, it shall be sufficient compliance with the requirements herein if purchases, sales and consumption of raw material and the gross income from services rendered is shown under broad heads.

(e) In the case of other companies, gross income derived under broad heads.

(iii) In the case of all concerns having works in progress, works-in-progress under broad heads.

(iv) (a) The aggregate, if material, of any amounts set aside or proposed to be set aside, to reserve, but not including provisions made to meet any specific liability, contingency or commitment known to exist at the date as to which the balance-sheet is made up.

(b) The aggregate, if material, of any amounts withdrawn from such reserves.

(v) (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 no longer required.

(vi) 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) Insurance .

(g) Rates and taxes, excluding, taxes on income.

(h) Miscellaneous expenses,

(vii) (a) Dividends from subsidiary companies.

(b) Provisions for losses of subsidiary companies.

(viii) 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 and consultation fees, interest, and other matters;

(c) Total value if all imported raw materials, spare parts and components consumed during the financial year and the total value of all indigenous raw materials, spare parts and components similarly consumed and the percentage of each to the total consumption;

(d) The amount remitted during the year in foreign currencies on account of dividends with a specific mention of the total number of non-resident shareholders, the total number of shares held by them on which the dividends were due and the year to which the dividends related;

(e) Earnings 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

Note: Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

GENERAL INSTRUCTIONS FOR THE PREPARATION OF CONSOLIDATED FINANCIAL STATEMENTS*

1. Where a company is required to prepare Consolidated Financial Statements, i.e., consolidated balance sheet and consolidated statement of profit and loss, the company shall *mutatis mutandis* follow the requirements of this Schedule as applicable to a company in the preparation of balance sheet and statement of profit and loss. In addition, the consolidated financial statements shall disclose the information as per the requirements specified in the applicable Accounting Standards including the following:

(i) Profit or loss attributable to "minority interest" and to owners of the parent in the statement of profit and loss shall be presented as allocation for the period.

---

* General instructions for preparation of Consolidated Financial Statements are part of Schedule III. Students at Intermediate (IPC) level may ignore these instructions as "Consolidated Financial Statements" are covered in Final syllabus.

(ii) "Minority interests" in the balance sheet within equity shall be presented separately from the equity of the owners of the parent.

2. In Consolidated Financial Statements, the following shall be disclosed by way of additional information:

Name of the entity in the	*Net Assets, i.e., total assets minus total liabilities*		*Share in profit or loss*	
	As % of consolidated net assets	*Amount*	*As % of consolidated profit or loss*	*Amount*
1	*2*	*3*	*4*	*5*
Parent Subsidiaries Indian 1. 2. 3. . . Foreign 1. 2. 3. . . Minority Interests in all subsidiaries Associates (Investment as per the equity method) Indian 1. 2. 3. . . Foreign 1. 2. 3.				

. . Joint Ventures (as per proportionate consolidation/investment as per the equity method) Indian 1. 2. 3. . . Foreign 1. 2. 3. . .				
TOTAL				

3. All subsidiaries, associates and joint ventures (whether Indian or foreign) will be covered under consolidated financial statements.
4. An entity shall disclose the list of subsidiaries or associates or joint ventures which have not been consolidated in the consolidated financial statements along with the reasons of not consolidating.