FINAL COURSE
PRACTICE MANUAL

PAPER : 1
FINANCIAL REPORTING

BOARD OF STUDIES
THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA

This Practice Manual has been prepared by the faculty of the Board of Studies. The objective of the study material is to provide teaching material to the students to enable them to obtain knowledge and skills in the subject. 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 Practice Manual 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.

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A WORD ABOUT PRACTICE MANUAL

The Board of Studies has been instrumental in imparting theoretical education for the students of Chartered Accountancy Course. The distinctive characteristic of the course i.e., distance education, has emphasized the need for bridging the gap between the students and the Institute and for this purpose, the Board of Studies has been providing a variety of educational inputs for the students. Bringing out a series of subject-wise Practice Manuals is one of the quality services provided by the Institute. These Practice Manuals are highly useful to the students preparing for the examinations, since they are able to get answers for all important questions relating to a subject at one place and that too, grouped chapter-wise.

The paper of Financial Reporting in the Final Course concentrates on understanding of the crucial aspects of preparing and analyzing financial statements. The importance of the subject of financial reporting is growing over the years due to various factors like liberalization, flow of cross-border capital, emergence of global corporations and movement towards better corporate governance practices. Standardization of accounting policies and financial reporting norms are significant aspects that make the subject more interesting in the recent years. The students are required to develop understanding of the Accounting Standards and the relevant Guidance Notes and should gain ability to apply the provisions contained therein under the given practical situations.

The Practice Manual in the subject of "Financial Reporting" is divided into ten chapters. It covers a wide range of practical questions and questions based on practical application of Accounting Standards and Guidance Notes. Care has been taken to present the chapters in the same sequence as prescribed in the syllabus to facilitate easy understanding by the students. The students are expected to cover the entire syllabus and also do the practice on their own while going through the Practice Manual. The main aim of this Practice Manual is to provide guidance as to the manner of writing answers in the examination. The main features of this Practice Manual are as follows:

- Important definitions, equations, formulae and basic concepts have been given before each topic for quick recapitulation.
- Compilation of questions from past examinations at Final Level as well as other important questions, which would facilitate in thorough understanding of the concepts contained in the chapters of the study material.
- Exercises have been given at the end of each topic for independent practice.
- The questions based on Financial Statements of the Companies have been revised as per Schedule III to the Companies Act, 2013.

The Practice Manual will serve as a useful and handy reference guide while preparing for Final Examination. Further, it will enhance the understanding about the pattern of questions set and the manner of answering such questions. It will enable solving the problems in the best possible manner and guide the students to improve their performance in the examinations. It will also help them to work upon their grey areas and plan a strategy to tackle theoretical as well as practical problems.

Any theoretical or practical questions added in the chapter have been highlighted with grey shading in the Practice Manual for easy identification and quick reference. Chapter 2 has been reworked completely based on the new topic added in the syllabus and Chapter 6 has been revised based on Ind AS 32, 107 and 109. To signify that both the chapters have been revised, they have been highlighted fully in grey shading.

Happy Reading and Best Wishes!

Group I : Paper 1 Financial Reporting
Statement showing Topic-wise distribution of Examination Questions alongwith Marks

	Syllabus contents	Syllabus covered in the examination held in																									
		Nov., 2010		May, 2011		Nov., 2011		May, 2012		Nov., 2012		May, 2013		Nov., 2013		May, 2014		Nov. ,2014		May, 2015		Nov., 2015		May, 2016		Nov., 2016	
		Q	M	Q	M	Q	M	Q	M	Q	M	Q	Q	M	Q	M	M	Q	M	Q	M	Q	M	Q	M	Q	M
1.	Accounting Standards and Guidance notes	1 7(a) 7(c) 7(d) 7(e)	**20** **4** **4** **4** **4** **36**	1 7(a) 7(b) 7(c) 7(d)	**20** **4** **4** **4** **4** **36**	1(a) 7(b)	**5** **4** **9**	1 7	**20** **20** **40**	1 7(b) 7(c) 7(d)	**20** **4** **4** **4** **32**	1 5(b) 7(b) 7(c) 7(d) 7(e)	**20** **6** **4** **4** **4** **4** **42**	1 7(b) 7(c) 7(d) 7(e)	**20** **4** **4** **4** **4** **36**	1 7(a) 7(c) 7(d) 7(e)	**20** **4** **4** **4** **4** **36**	1 7	**20** **16** **36**	1 7	**20** **20** **40**	1(a) 1(b) 1(d) 7(a) 7(b) 7(c) 7(d)	**5** **5** **5** **4** **4** **4** **4** **31**	1(a) 1(b) 1(c) 4(c) 5(b) 7(c) 7(e)	**5** **5** **5** **4** **4** **4** **4** **31**	1(a) 1(b) 1(c) 1(d) 7(b) 7(d) 7(e)	**5** **5** **5** **5** **4** **4** **4** **32**
2.	Introduction of Indian Accounting Standards (Ind AS); Comparative study of ASs vis-a-vis Ind ASs; Carve outs/ins in Ind ASs vis-à-vis International Financial Reporting Standards (IFRSs).																							7(d)	**4**	5(b)	**8**
3.	Corporate Financial Reporting					1(b)	**5**			6(c)	**4**											7(e)	**4**				
4.	Accounting for Corporate Restructuring	4	**16**	3 4(a)	**16** **8** **24**	3	**16**	3 4	**16** **16** **32**	3 6(a)	**16** **8** **24**	3	**16**	2	**16**	5	**16**	2	**16**	2	**16**	2	**16**	2	**16**	2	**16**
5.	Consolidated Financial Statements of	3	**16**	2	**16**	2 4(b)	**16** **8**	2	**16**	2	**16**	2	**16**	4	**16**	3	**16**	3	**16**	3	**16**	3	**16**	3	**16**	3	**16**

	Group							24																				
6.	Accounting and Reporting of Financial Instruments.		5(b) 6(a)	8 8 16			7(a) 7(c) 7(e)	4 4 4 12	5(a)	8					3(b) 7(a)	6 4 10			4(b)	4	4(b)	8	4(b)	8	4(b) 7(b)	8 4 12	7(a) 7(c)	4 4 8
7.	Share based payments		2	16			1(c)	5			7(a)	4	4(b)	4	3(a)	10	4(a)	8	4(a)	12			4(a)	8	5(c)	4	6(a)	10
8.	Financial Reporting for Financial Institutions				6(b)	6	6(b) 7(d)	8 4 12			4(a) 5(b)	10 6 16	6(b) 7(a)	8 4 12			4(b) 7(b)	4 4 8			4(a)	8	1(c)	5	6(b)	8	4(b)	4
9.	Valuation																											
	Unit 1	Concept of Valuation.																										
	Unit 2	Valuation of Tangible Fixed Assets																										
	Unit 3	Valuation of Intangibles			4(b) 7(e)	8 4 12					4(b)	6	5(a)	10	5 6(b)	16 8 24					5(b)	8	5(b) 6(b)	6 8 14				
	Unit 4	Valuation of Liabilities	6(b)	8																								
	Unit 5	Valuation of Shares	5(a)	8	5	16	5	16			5(a)	10	4(a)	12			2	16	5	16					1(d) 4(a)	5 8 13	4(a)	12
	Unit	Valuation of							6(a)	12											5(a)	8	5(a)	10	5(a)	8		

	6	Business																										
10	Developments in Financial Reporting																											
	Unit 1	Value Added Statement					4(a)	**8**	5(b)	**8**			6(a)	**8**	6(a)	**16**					6(a)	**8**			6(a)	**8**	5(a)	**8**
	Unit 2, 3 & 4	Economic Value Added, Market Value Added, Shareholders' Value Added			6(a)	**5**	6(a)	**8**	6(b)	**4**	7(e)	**4**					4(c) 6(b)	**4** **8** **12**	6(a) 6(b)	**8** **8** **16**			6(a)	**8**			6(b)	**6**
	Unit 5	Human Resource Reporting			6(c)	**5**	1(d)	**5**			6(b)	**4**					6(a)	**8**							7(a)	**4**		

Note:

1. **'Q' represents question numbers as they appeared in the question paper of respective examination. 'M' represents the marks which each question carried in that examination. The question papers of all the past attempts of Final Examination can be accessed from the BOS Knowledge Portal on the Institute website www.icai.org.**
2. **Chapter 2 "Introduction of Indian Accounting Standards (Ind AS); Comparative study of ASs vis-a-vis Ind ASs; Carve outs/ins in Ind ASs vis-à-vis International Financial Reporting Standards (IFRSs)" has been newly added in the syllabus in place of the topic "Overview of International Accounting Standards (IAS) / International Financial Reporting Standards (IFRS), Interpretations by International Financial Reporting Interpretation Committee (IFRIC), Significant difference vis-a-vis Indian Accounting Standards" relevant from May, 2016 examination. Therefore, questions came in May, 2016 and Nov. 2016 only are appearing in the matrix.**

CONTENTS

1

Accounting Standards and Guidance Notes

BASIC CONCEPTS

- **ACCOUNTING STANDARDS**

  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.

- **GUIDANCE NOTES**

  Guidance Notes are primarily designed to provide guidance to members of ICAI on matters which may arise in the course of their professional work and on which they may desire assistance in resolving issues which may pose difficulty. Guidance Notes are recommendatory in nature. In a situation where certain matters are covered both by an Accounting Standard and a Guidance Note, issued by the Institute of Chartered Accountants of India, the Guidance Note or the relevant portion thereof will be considered as superseded from the date of the relevant Accounting Standard coming into effect, unless otherwise specified in the Accounting Standard.

General Questions

Question 1

Write short note on the advantages and disadvantages of setting of Accounting Standards.

Answer

The Accounting Standards seek to describe the accounting principles, the valuation techniques and the methods of applying the accounting principles in the preparation and presentation of financial statements so that they may give a true and fair view. The ostensible purpose of the standard setting bodies is to promote the dissemination of timely and useful financial information to investors and certain other parties having an interest in companies' economic performance.

The advantages or benefits of accounting standards may be summarized as follows:

(i) **To improve the credibility and reliability of financial statements:** The accounting standards create an environment of confidence amongst the users of the accounting information by providing a uniform structure of uniform guidelines which provide credibility and reliability to the accounting information. In this way the financial statements present a true and fair view of the financial position and operating results (profit or loss) of a business organisation.

(ii) **Comparability:** The value of accounting information is enhanced (increased) if it can be compared easily in the same line of business activity. The comparability is possible only when same accounting standards are used in the preparation of the financial statements of different firms in the same industry. It is a positive step to protect the interests of the users of the accounting information.

(iii) **Benefits to accountants and auditors:** The accounting standards provide a basis for uniform accounting practices. In this way there is a less possibility of frauds to be committed by accountants. There is more transparency in the accounting information. Since the accounting profession follows the accounting standards without any exception, they are helpful not only to an accounting entity but to the accountants and auditors too.

(iv) **Additional disclosures:** There are certain areas where important information is not required to be disclosed by law. Standards require such additional disclosure such as the methods of depreciation used, change of method of depreciation etc. which help the users of financial statements such as investors, bankers, trade payables etc. to take important financial decisions.

(v) **Evaluation of managerial ability:** Accounting standards are useful in measuring the efficiency of management regarding the profitability, liquidity, solvency and general progress of the enterprise. In the absence of accounting standards, it would be difficult to evaluate the managerial efficiency, because there is no basis of comparing the financial results of one enterprise with that of another. Each enterprise would evolve its own rules or standards to suit its purpose and users of accounting information would fail to get a true and fair view of the functioning of an enterprise.

(vi) **Helpful to Government:** The government officials will find the financial information more useful for purposes of economic planning, market analysis and tax collections if it is based on established accounting standards.

(vii) **Reform in accounting theory:** The development of accounting standards has been very helpful in reforming accounting theory and practice in respect of accounting measurements and financial Information.

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

(i) **Difficult choice:** Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.

(ii) **Mechanical approach:** There may be a trend towards rigidity and away from flexibility in applying the accounting standards.

(iii) **Different from law:** Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

Question 2

Discuss the concept of cost v/s fair value with reference to Accounting Standards.

Answer

Cost vs. Fair value

Cost basis: The term cost refers to cost of purchase, costs of conversion on other costs incurred in bringing the goods to its present condition and location. 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.

Fair value: Fair value of an asset is the amount at which an enterprise expects to exchange an asset between knowledgeable and willing parties in an arm's length transaction. Fair value concept requires a lot of estimation and to the extent, it is subjective in nature.

Accounting Standards are generally based on historical cost with a very few exceptions:

- AS 2 "Valuation of Inventories"– Inventories are valued at net realizable value (NRV) if cost of inventories is more than NRV.
- AS 10 "Property, plant and Equipment"– AS 10 has been revised in 2016. At various places like in determination of cost, revaluation and depreciation, fair value has to be considered. For eg-
  - Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.
  - One or more items of property, plant and equipment may be acquired in exchange for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such an item of property, plant and equipment is measured at fair value. If an enterprise is able to measure reliably the fair value of either the asset received or the asset given up, then the fair value of the asset given up is used to measure the cost of the asset received unless the fair value of the asset received is more clearly evident.
  - Where several items of property, plant and equipment are purchased for a consolidated price, the consideration is apportioned to the various items on the basis of their respective fair values at the date of acquisition. In case the fair values of the items acquired cannot be measured reliably, these values are estimated on a fair basis as determined by competent valuers.

- After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably should be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations should be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.
- Depreciation is recognised even if the fair value of the asset exceeds its carrying amount, as long as the asset's residual value does not exceed its carrying amount.

- AS 13 "Accounting for Investments"– Current investments are carried at lower of cost and fair value. The carrying amount of long term investments is reduced to recognize the permanent decline in value.
- AS 15 "Employee Benefits"– The provision for defined benefits is made at fair value of the obligations.
- AS 26 "Intangible Assets"– 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.
- AS 28 "Impairment of Assets"– Provision is made for impairment of assets.

Question 3

XYZ Ltd., with a turnover of ₹ 35 lakhs and borrowings of ₹ 10 lakhs during any time in the previous year, wants to avail the exemptions available in adoption of Accounting Standards applicable to companies for the year ended 31.3.2017. Advise the management on the exemptions that are available as per the Companies (AS) Rules, 2006.

If XYZ is a partnership firm is there any other exemptions additionally available.

Answer

The question deals with the issue of Applicability of Accounting Standards for corporate &non-corporate.

The companies can be classified under two categories viz SMCs and Non SMCs under the Companies (AS) Rules, 2006.

As per the Companies (AS) Rules, 2006, criteria for above classification as SMCs, are:

"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.

Since, XYZ Ltd.'s turnover of ₹ 35lakhs does not exceed ₹ 50 crores & borrowings of ₹ 10 lakhs is less than ₹ 10 crores, it is a small and medium sized company

The following relaxations and exemptions are available to XYZ Ltd.

1. AS 3 "Cash Flow Statements" is not mandatory.
2. AS 17 "Segment Reporting" is not mandatory.
3. SMEs are exempt from some paragraphs of AS 19 "Leases".
4. SMEs are exempt from disclosures of diluted EPS (both including and excluding extraordinary items).
5. SMEs 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 under AS 28 "Impairment of Assets".
6. SMEs are exempt from disclosure requirements of paragraphs 66 and 67 of AS 29 "Provisions, Contingent Liabilities and Contingent Assets".
7. SMEs are exempt from certain requirements of AS 15 "Employee Benefits".
8. Accounting Standards 21, 23, 27 are not applicable to SMEs.

However, if XYZ is a partnership firm and not a corporate, then its classification will be done on the basis of the classification of non-corporate entities as prescribed by the ICAI. Accordingly, to ICAI, non-corporate entities can be classified under 3 levels viz Level I, Level II (SMEs) and Level III (SMEs).

Since, turnover of XYZ, a partnership firm is less than ₹ 1 crore & borrowings of ₹ 10 lakhs is less than ₹ 1 crore, therefore, it will be classified as Level III SME. In this case, AS 3, AS 17, AS 18, AS 21, AS 23, AS 24, AS 27 will not be applicable to XYZ a partnership firm. Relaxations from certain requirements in respect of AS 15, AS 19, AS 20, AS 25, AS 28 and AS 29 are also available to XYZ a partnership firm.

Question 4

A company was classified as Non-SMC in 2015-2016. In 2016-2017 it has been classified as SMC. The management desires to avail the exemption or relaxations available for SMCs in 2016-2017. However, the accountant of the company does not agree with the same. Comment.

Answer

As per Rule 5 of the Companies (Accounting Standards) Rules, 2006, an existing company, which was previously not an 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. Therefore, the management of the company cannot avail the exemptions available with the SMCs for the year ended 31st March, 2017.

Question 5

X Ltd. sold its building to Mini Ltd. for ₹ 60 lakhs on 30.09-2016 and gave possession of the property to Mini Ltd. However, documentation and legal formalities are pending. Due to this, the company has not recorded the sale and has shown the amount received as an advance. The book value of the building is ₹ 25 lakhs as on 31st March, 2017. Do you agree with this treatment? If you do not agree, explain the reasons with reference to the accounting standard.

Answer

Principles of prudence, substance over form and materiality should be looked into, to ensure true and fair consideration in a transaction. In the given case, the economic reality and substance of the transaction is that the rights and beneficial interest in the property has been transferred although legal title has not been transferred. Hence, X Ltd. should record the sale and recognize the profit of ₹ 35 lakhs in its financial statements for the year ended 31st March, 2017; value of building should be removed from the balance sheet. Therefore, the treatment given by the company is not correct.

Guidance Notes

Question 6

Write short notes on:

(i) Graded vesting under an employee stock option plan.

(ii) Presentation of MAT credit in the financial statements.

Answer

(i) Graded vesting under an employee stock option plan: In case the options/shares granted under an employee stock option plan do not vest on one date but have graded vesting schedule, total plan should be segregated into different groups, depending upon the vesting dates. Each of such groups would be having different vesting period and expected life and, therefore, each vesting date should be considered as a separate option grant and evaluated and accounted for accordingly. For example, suppose an employee is granted 100 options which will vest @ 25 options per year at the end of the third, fourth, fifth and sixth years. In such a case, each tranche of 25 options would be evaluated and accounted for separately.

(ii) Presentation of MAT credit in the financial statements:

Balance Sheet: Where a company recognizes MAT credit as an asset on the basis of the considerations specified in the Guidance Note on Accounting for Credit Available in respect of Minimum Alternate Tax under the Income Tax Act, 1961, the same should be presented under the head 'Loans and Advances'* since, there being a convincing evidence of realization of the asset, it is of the nature of a pre-paid tax which would be adjusted against the normal income tax during the specified period. The asset may be reflected as 'MAT credit entitlement'.

In the year of set-off of credit, the amount of credit availed should be shown as a deduction from the 'Provision for Taxation' on the liabilities side of the balance sheet. The unavailed amount of MAT credit entitlement, if any, should continue to be presented under the head 'Loans and Advances' if it continues to meet the considerations stated in paragraph 11 of the Guidance Note.

Profit and Loss Account: According to explanation given for paragraph 21 of Accounting Standard 22, "Accounting for Taxes on Income" in the context of Section 115JB of the Income-tax Act, 1961, MAT is the current tax. Accordingly, the tax expense arising on account of payment of MAT should be charged at the gross amount, in the normal way, to the statement of profit and loss in the year of payment of MAT. In the year in which the MAT credit becomes eligible to be recognized as an asset in accordance with the recommendations contained in this Guidance Note, the said asset should be created by way of a credit to the statement of profit and loss and presented as a separate line item therein.

Question 7

HSL Ltd. is manufacturing goods for local sale and exports. As on 31st March, 2017, it has the following finished inventory in the factory warehouse:

(i) Goods meant for local sales ₹ 100 lakhs (cost ₹ 75 lakhs)

(ii) Goods meant for exports ₹ 50 lakhs (cost ₹ 20 lakhs)

Excise duty is payable at the rate of 12%. The company's Managing Director says that excise duty is payable only on clearance of goods and hence not a cost. Please advise HSL using guidance note, if any issued on this, including valuation of inventory.

Answer

According to Central Excise Rules, 2002, excise duty is levied upon the manufacture or production of goods. However, it is collected only at the time of removal of goods from factory premises or factory warehouse.

Guidance Note on 'Accounting Treatment for Excise Duty' says that excise duty is a duty on manufacture or production of excisable goods in India.

** As per Schedule III to the Companies Act, 2013, it should be presented under the head 'Non-current Assets' sub head 'Long-term Loans and Advances'.*

As explained in the Guidance Note, the liability for excise duty arises at the point of time at which the manufacture is completed. The excise duty paid or provided on finished goods should, therefore, be included in inventory valuation.

Further, the Guidance Note states that excise duty should be considered as a manufacturing expense and like other manufacturing expenses are considered as an element of cost for the purpose of inventory valuation, excise duty should also be considered as an element of cost while valuing the inventory.

Therefore, in the given case of HSL Ltd., the Managing Director's contention that "excise duty is payable only on clearance of goods and hence is not a cost" is incorrect. Excise duty on the goods meant for local sales should be provided for at the rate of 12% on the selling price, that is, on ₹ 100 lakhs for valuation of inventory.

Excise duty on goods meant for exports, should also be provided for, since the liability for excise duty arises when the manufacture of the goods is completed. However, if it is assumed that all the conditions specified in Rule 19 of the Central Excise Rules, 2002 regarding export of excisable goods without payment of duty are fulfilled by HSL Ltd. excise duty may not be provided for.

Question 8

W Ltd. purchased machinery for ₹ 80 lakhs from X Ltd. during 2016-17 and installed the same immediately. Price includes excise duty of ₹ 8 lakhs. During the year 2016-17, the company produced excisable goods on which excise duty of ₹ 7.20 lakhs was charged.

Give necessary entries explaining the treatment of CENVAT credit.

Answer

Journal Entries

			₹ in lakhs	
(a)	Machinery A/c	Dr.	72	
	CENVAT credit A/c	Dr.	8	
	To Bank A/c or trade payables A/c			80
	(Being capitalization of machinery)			
	CENVAT credit deferred A/c	Dr.	4.0	
	CENVAT credit receivable on capital goods A/c	Dr.	4.0	
	To CENVAT credit A/c			8.0
	(Being 50% of CENVAT credit transferred to receivable A/c and remaining deferred)			

(b)	Excise duty A/c	Dr.	7.2	
	To CENVAT credit receivable on capital goods A/c			4.0
	To Bank A/c			3.2
	(Being excise duty set off to the extent of 50% of excise duty paid in the first year of acquisition of capital asset)			

Question 9

C Ltd. is a group engaged in manufacture and sale of industrial and FMCG products. One of their division also deals in Leasing of properties - Mobile Towers. The accountant showed the rent arising from the leasing of such properties as other income in the Statement of Profit and Loss.

Comment whether the classification of the rent income made by the accountant is correct or not in the light of Schedule III to the Companies Act, 2013.

Answer

As per the "General Instructions for preparation of Statement of Profit and Loss" given in Schedule III to the Companies Act, 2013, "Other Income" does not include operating income. The term "Revenue from operations" has not been defined under Schedule III to the Companies Act, 2013. However, as per the Guidance Note on Schedule III to the Companies Act, 2013 this would include revenue arising from a company's operating activities, i.e., either its principal or ancillary revenue-generating activities. Whether a particular income constitutes "Revenue from operations" or "Other income" is to be decided based on the facts of each case and detailed understanding of the company's activities. The classification of income would also depend on the purpose for which the particular asset is acquired or held.

As per the information given in the question, C Ltd. is a group engaged in manufacture and sale of industrial and FMCG products and its one of the division deals in leasing of properties - Mobile Towers. Since its one division is continuously engaged in leasing of properties, it shall be considered as its principal or ancillary revenue-generating activities. Therefore, the rent arising from such leasing shall be shown under the head "Revenue from operations" and not as "other income".

Hence, the presentation of rent arising from the leasing of such properties as "other income" in the Statement of Profit and Loss is not correct. It should be shown under the head "Revenue from operations".

Accounting Standard 1

Question 10

Write short note on 'Concept of Materiality'.

Answer

Para 17 of AS 1 'Disclosure of Accounting Policies', states that financial statements should disclose all material items, i.e., items the knowledge of which might influence the decisions of the user of the financial statements. Materiality depends on the size of item or error judged in the particular circumstances of its omission or misstatement. From a positive perspective, materiality has to do with the significance of an item or event to warrant attention in the accounting process. From a negative view point, materiality is critical because otherwise a great deal of time might be spent on trivial matters in the accounting process. Individual judgments are required to assess materiality, or to decide what the appropriate minimum quantitative criteria are to be set for given situations. What is material to one organization, may not be material for another organization.

For example, a long term investor is interested in the current value of fixed asset like building, while the banker may not consider it significant for a short-term loan. Similarly, a pair of scissors, ball pens, sharpeners, waste-paper baskets could be used for a number of years but still it is treated as an expense and not an asset. The omission of "paise" in the financial statements is also due to their insignificant effect to the users of the financial statement in making a decision.

Example: Requirements as to the Statement of Profit & Loss; Part II of Schedule III of the Companies Act, 2013

- Any item under which the income or expenditure exceeds 1 per cent of the revenue or ₹ 1,00,000, whichever is higher, is to be shown as a separate and distinct item against appropriate account head in the Statement of Profit & Loss.
- Broad heads shall be decided taking into account the concept of materiality and presentation of true and fair view of financial statements.

The relevance of information is affected by its materiality. Information is material if its misstatements (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information. Materiality 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.

Accounting Standard 2

Question 11

A private limited company manufacturing fancy terry towels had valued its closing inventory of inventories of finished goods at the realisable value, inclusive of profit and the export cash incentives. Firm contracts had been received and goods were packed for export, but the ownership in these goods had not been transferred to the foreign buyers.

Comment on the valuation of the inventories by the company.

Answer

Accounting Standard 2 "Valuation of Inventories" states that inventories should be valued at lower of historical cost and net realizable value. AS 9 on "Revenue Recognition" states, "at certain stages in specific industries, such as when agricultural crops have been harvested or mineral ores have been extracted, performance may be substantially complete prior to the execution of the transaction generating revenue. In such cases, when sale is assured under forward contract or a government guarantee or when market exists and there is a negligible risk of failure to sell, the goods invoiced are often valued at net realisable value."

Terry Towels do not fall in the category of agricultural crops or mineral ores. Accordingly, taking into account the facts stated, the closing inventory of finished goods (Fancy terry towel) should have been valued at lower of cost and net realisable value and not at net realisable value. Further, export incentives are recorded only in the year the export sale takes place. Therefore, the policy adopted by the company for valuing its closing inventory of inventories of finished goods is not correct.

Question 12

U.S.A Ltd. purchased raw material @ ₹ 400 per kg. Company does not sell raw material but uses in production of finished goods. The finished goods in which raw material is used are expected to be sold at below cost. At the end of the accounting year, company is having 10,000 kg of raw material in inventory. As the company never sells the raw material, it does not know the selling price of raw material and hence cannot calculate the realizable value of the raw material for valuation of inventories at the end of the year. However replacement cost of raw material is ₹ 300 per kg. How will you value the inventory of raw material?

Answer

As per Para 24 of AS 2 (Revised) "Valuation of Inventories", materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when there has been a decline in the price of materials and it is estimated that the cost of the finished products will exceed net realizable value, the materials are written down to net realizable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realizable value. Therefore, in this case, USA Ltd. will value the inventory of raw material at ₹ 30,00,000 (10,000 kg. @ ₹ 300 per kg.).

Question 13

Night Ltd. sells beer to customers. Some of the customers consume the beer in the bars run by Night Limited. While leaving the bars, the consumers leave the empty bottles in the bars and the company takes possession of these empty bottles. The company has laid down a detailed internal record procedure for accounting for these empty bottles which are sold by the company by calling for tenders. Keeping this in view:

(i) Decide whether the inventory of empty bottles is an asset of the company;

(ii) If so, whether the inventory of empty bottles existing as on the date of Balance Sheet is to be considered as inventories of the company and valued as per AS2 or to be treated as scrap and shown at realizable value with corresponding credit to 'Other Income'?

Answer

(i) Tangible objects or intangible rights carrying probable future benefits, owned by an enterprise are called assets. Night Ltd. sells these empty bottles by calling tenders. It means further benefits are accrued on its sale. Therefore, empty bottles are assets for the company.

(ii) As per AS 2 "Valuation of Inventories", inventories are assets held for sale in the ordinary course of business. Inventory of empty bottles existing on the Balance Sheet date is the inventory and Night Ltd. has detailed controlled recording and accounting procedure which duly signify its materiality. Hence inventory of empty bottles cannot be considered as scrap and should be valued as inventory in accordance with AS 2.

Question 14

Anil Pharma Ltd. ordered 16,000 kg of certain material at ₹ 160 per unit. The purchase price includes excise duty ₹ 10 per kg in respect of which full CENVAT credit is admissible. Freight incurred amounted to ₹ 1,40,160. Normal transit loss is 2%. The company actually received 15,500 kg and consumed 13,600 kg of material. Compute cost of inventory under AS 2 and amount of abnormal loss.

Answer

Calculation of total cost of material

	₹
Purchase price (16,000 kg. x ₹ 160)	25,60,000
Less: CENVAT credit (16,000 kg. x ₹ 10)	(1,60,000)
	24,00,000
Add: Freight	1,40,160
Total material cost	25,40,160

Number of units after normal loss = 16,000 kg. x (100 - 2)% = 15,680 kg

Revised cost per kg. = $\frac{25,40,160}{15,680 \text{ kg}}$ = ₹ 162

Closing inventory = Material actually received – Material consumed

= 15,500 kg – 13,600 kg = 1,900 kg

Value of closing inventory = 1,900 kg x ₹ 162 = ₹ 3,07,800

Abnormal loss in kg = 15,680 kg. – 15,500 kg = 180 kg.

Abnormal loss in value = 180 kg x ₹ 162 = ₹ 29,160

Question 15

In a manufacturing process of Vijoy Limited, one by-product BP emerges besides two main products MP1 and MP2 apart from scrap. Detail of cost of production process is here under:

Item	*Unit*	*Amount (₹)*	*Output (unit)*	*Closing inventory as on 31-03-2017*
Raw material	*15,000*	*1,60,000*	*MP1-6,250*	*800*
Wages	*-*	*82,000*	*MP2- 5,000*	*200*
Fixed overhead	*-*	*58,000*	*BP-1,600*	*-*
Variable overhead	*-*	*40,000*	*-*	*-*

Average market price of MP1 and MP2 is ₹ 80 per unit and ₹ 50 per unit respectively, by-product is sold @ ₹ 25 per unit. There is a profit of ₹ 5,000 on sale of by-product after incurring separate processing charges of ₹ 4,000 and packing charges of ₹ 6,000, ₹ 6,000 was realised from sale of scrap.

Calculate the value of closing inventory of MP1 and MP2 as on 31-03-2017.

Answer

As per para 10 of AS 2 'Valuation of Inventories', most by-products as well as scrap or waste materials by their nature, are immaterial. They are often measured at net realizable value and this value is deducted from the cost of the main product.

1. Calculation of net realizable value of by-product, BP

		₹
Selling price of by-product BP	(1,600 units x ₹ 25 per unit)	40,000
Less: Separate processing charges of by-product BP		(4,000)
Packing charges		(6,000)
Net realizable value of by-product BP		30,000

2. Calculation of cost of conversion for allocation between joint products MP1 and MP2

	₹	₹
Raw material		1,60,000
Wages		82,000
Fixed overhead		58,000
Variable overhead		40,000
		3,40,000
Less: NRV of by-product BP (See calculation 1)	(30,000)	
Sale value of scrap	(6,000)	(36,000)
Joint cost to be allocated between MP1 and MP2		3,04,000

3. Determination of "basis for allocation" and allocation of joint cost to MP1 and MP2

	MP1	*MP2*
Output in units (a)	6,250 units	5,000 units
Sales price per unit (b)	₹ 80	₹ 50
Sales value (a x b)	₹ 5,00,000	₹ 2,50,000
Ratio of allocation	2	1
Joint cost of ₹ 3,04,000 allocated in the ratio of 2:1 (c)	₹ 2,02,667	₹ 1,01,333
Cost per unit [c/a]	₹ 32.43	₹ 20.27

4. Determination of value of closing inventory of MP1 and MP2

	MP1	*MP2*
Closing inventory in units	800 units	200 units
Cost per unit	₹ 32.43	₹ 20.27
Value of closing inventory	₹ 25,944	₹ 4,054

Question 16

Sun Ltd. has fabricated special equipment (solar power panel) during 2014-15 as per drawing and design supplied by the customer. However due to a liquidity crunch, the customer has requested the company for postponement in delivery schedule and requested the company to withhold the delivery of finished goods products and discontinue the production of balance items.

As a result of the above, the details of customer balance and the goods held by the company as work-in-progress and finished goods as on 31-03-2016 are as follows:

Solar power panel (WIP)	*` 85 lakhs*
Solar power panel (finished products)	*` 55 lakhs*
Sundry Debtor (solar power panel)	*` 65 lakhs*

The petition for winding up against the customer has been filed during 2015-16 by Sun Ltd.

Comment with explanation on provision to be made of ` 205 lakh included in Sundry Debtors, Finished goods and work-in-progress in the financial statement of 2015-16.

Answer

From the fact given in the question it is obvious that Sun Ltd. is a manufacturer of solar power panel. As per AS 2 'Valuation of Inventories', inventories are assets (a) held for sale in the ordinary course of business; (b) in the process of production for such sale; or (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services. Therefore, solar power panel held in its stock will be considered as its inventory. Further, as per the standard, inventory at the end of the year are to be valued at lower of cost or NRV.

As the customer has postponed the delivery schedule due to liquidity crunch the entire cost incurred for solar power panel which were to be supplied has been shown in Inventory. The solar power panel are in the possession of the Company which can be sold in the market. Hence company should value such inventory as per principle laid down in AS 2 i.e. lower of Cost or NRV. Though, the goods were produced as per specifications of buyer the Company should determine the NRV of these goods in the market and value the goods accordingly. Change in value of such solar power panel should be provided for in the books. In the absence of the NRV of WIP and Finished product given in the question, assuming that cost is lower, the company shall value its inventory as per AS 2 for ₹ 140 lakhs [i.e solar power panel (WIP) ₹ 85 lakhs + solar power panel (finished products) ₹ 55 lakhs].

Alternatively, if it is assumed that there is no buyer for such fabricated solar power panel, then the NRV will be Nil. In such a case, full value of finished goods and WIP will be provided for in the books.

As regards Sundry Debtors balance, since the Company has filed a petition for winding up against the customer in 2015-16, it is probable that amount is not recoverable from the party. Hence, the provision for doubtful debts for ₹ 65 lakhs shall be made in the books against the debtors amount.

Accounting Standard 3

Question 17

Explain the difference between direct and indirect methods of reporting cash flows from operating activities with reference to Accounting Standard 3 revised.

Answer

As per para 18 of AS 3 (Revised) on Cash Flow Statements, an enterprise should report cash flows from operating activities using either:

(a) the direct method whereby major classes of gross cash receipts and gross cash payments are disclosed; or

(b) the indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The direct method provides information which may be useful in estimating future cash flows and which is not available under the indirect method and is, therefore, considered more appropriate than the indirect method. Under the direct method, information about major classes of gross cash receipts and gross cash payments may be obtained either:

(a) from the accounting records of the enterprise; or

(b) by adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial enterprise) and other items in the statement of profit and loss for:

(i) changes during the period in inventories and operating receivables and payables;

(ii) other non-cash items; and

(iii) other items for which the cash effects are investing or financing cash flows.

Under the indirect method, the net cash flow from operating activities is determined by adjusting net profit or loss for the effects of:

(a) changes during the period in inventories and operating receivables and payables;

(b) non-cash items such as depreciation, provisions, deferred taxes, and unrealized foreign exchange gains and losses; and

(c) all other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the operating revenues and expenses, excluding non-cash items disclosed in the statement of profit and loss and the changes during the period in inventories and operating receivables and payables.

Question 18

Bellhop LLC submits the following information pertaining to year 2016-2017. Using the data, you are required to find the ending cash and bank balances given an opening figure thereof was ₹ 1.55 million.

	(₹ millions)
Additional shares issued	*6.50*
CAPEX (Capital expenditure)	*9.90*
Proceeds from assets sold	*1.60*
Dividends declared	*0.50*
Gain from disposal of assets	*(1.20)*
Net income	*3.30*
Increase in Accounts Receivable	*1.50*
Redemption of 4.5% debentures	*2.50*
Depreciation & Amortization	*0.75*

Answer

Bellhop LLC

Cash Flow Statement for the year ended 31st March, 2017

	₹ *in millions*	₹ *in millions*
Cash flows from operating activities		
Net income	3.30	
Add: Depreciation & amortization	0.75	
Loss from disposal of assets	1.20	
Less: Increase in accounts receivables	(1.50)	
Net cash generated from operating activities		3.75
Cash flows from investing activities		
Capital expenditure	(9.90)	
Proceeds from sale of fixed assets	1.60	
Net cash used in investing activities		(8.30)
Cash flows from financing activities		
Proceeds from issuance of additional shares	6.50	
Dividend declared	(0.50)	
Redemption of 4.5% debentures	(2.50)	
Net cash generated from financing activities		3.50
Net decrease in cash		(1.05)
Cash at beginning of the period		1.55
Cash at end of the period (Balancing figure)		0.50

Accounting Standard 4

Question 19

A company deals in petroleum products. The sale price of petrol is fixed by the government. After the Balance Sheet date, but before the finalisation of the company's accounts, the government unexpectedly increased the price retrospectively. Can the company account for additional revenue at the close of the year? Discuss.

Answer

According to para 8 of AS 4 (Revised 1995), the unexpected increase in sale price of petrol by the government after the balance sheet date cannot be regarded as an event occurring after the Balance Sheet date, which requires an adjustment at the Balance Sheet date, since it does not represent a condition present at the balance sheet date. The revenue should be recognized only in the subsequent year with proper disclosures. The retrospective increase in the petrol price should not be considered as a prior period item, as per AS 5, because there was no error in the preparation of previous period's financial statements.

Question 20

While preparing its final accounts for the year ended 31st March, 2017, a company made a provision for bad debts @ 5% of its total trade receivables. In the last week of February 2017, trade receivables for 2 lakhs had suffered heavy loss due to earthquake. The loss was not covered by any insurance policy. In April, 2017, the trade receivable became bankrupt. Can the company provide for full loss arising out of insolvency of trade receivable in the final accounts for year ended 31st March, 2017?

Answer

As per Para 8.2 and 13 of Accounting Standard 4 'Contingencies and Events occurring after the Balance Sheet Date', assets and liabilities should be adjusted for events occurring after the date of balance sheet, that provide additional evidence to assist estimation of amounts relating to conditions existing at the Balance Sheet date. Therefore, in the given case, full provision for bad debt amounting ₹ 2 lakhs should be made to cover the loss arising due to insolvency in the final accounts for the year ended 31st March, 2017 as earthquake took place before the balance sheet date.

Accounting Standard 5

Question 21

Omega Ltd. 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 2015-2016, the company has regularly included such charges in the valuation of closing inventory. This being in the nature of interest the company has decided to exclude it from closing inventory valuation for the year 2016-2017. This would result into decrease in profit by ₹ 7.60 lakhs. How would you deal with the following in the annual accounts of a company for the year ended 31st March, 2017?

Answer

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

a. It is required by statute, or

b. for compliance with an accounting standard, or

c. 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 inventory 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.

Disclosure: As per AS 2, this accounting policy adopted for valuation of inventories including the cost formulae used should be disclosed in the financial statements in Notes to Accounts.

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 inventory unlike preceding years. Had the company continued the accounting practice followed earlier, the value of closing inventory as well as profit before tax for the year would have been higher by ₹ 7.60 lakhs."

Question 22

State, how you will deal with in the accounts of U Ltd. for the year ended 31st March, 2017 with reference to Accounting Standard when the company finds that the inventory sheets of 31.3.2016 did not include two pages containing details of inventory worth ₹ 14.5 lakhs.

Answer

Paragraph 4 of Accounting Standard 5 on "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", defines Prior Period items as "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".

Rectification of error in inventory valuation is a prior period item vide para 4 of AS 5. ₹ 14.5 lakhs must be added to the opening inventory of 1/4/2016. It is also necessary to show ₹ 14.5 lakhs as a prior period adjustment in the Profit and loss Account. Separate disclosure of this item as a prior period item is required as per Para 15 of AS 5.

Question 23

During the course of the last three years, a company owning and operating Helicopters lost four Helicopters. The company Accountant felt that after the crash, the maintenance provision created in respect of the respective helicopters was no longer required, and proposed to write back to the Profit and Loss account as a prior period item.

Is the Company's proposed accounting treatment correct? Discuss.

Answer

The balance amount of maintenance provision written back to profit and loss account, no longer required due to crash of the helicopters, is not a prior period item because there was no error in the preparation of previous periods' financial statements. The term 'prior period items', as defined in AS 5 (revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", refer 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. As per paragraph 8 of AS 5, 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. The amount so written-back (If material) should be disclosed as an extraordinary item as per AS 5.

Question 24

M/s Dinesh & Company signed an agreement with workers for increase in wages with retrospective effect. The outflow on account of arrears was for 2013-2014— ₹ 10.00 lakhs, for 2014-2015— ₹ 12.00 lakhs and for 2015-2016— ₹ 12.00 lakhs. This amount is payable in September, 2016. The accountant wants to charge ₹ 22.00 lakhs as prior period charges in financial statement for 2016-17. Discuss.

Answer

According to AS 5 (Revised) "Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies", the term prior period item refers only to income or expenses which arise in the current period as a result of errors or omission 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. The full amount of wage arrears paid to workers will be treated as an expense of current year and it will be charged to profit and loss account as current expenses and not as prior period expenses.

It may be mentioned that additional wages is an expense arising from the ordinary activities of the company. Although abnormal in amount, such an expense does not qualify as an extraordinary item. However, as per Para 12 of AS 5 (Revised), 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.

Question 25

X Limited was making provisions up to 31-3-2016 for non-moving inventories based on no issues for the last 12 months. Based on a technical evaluation the company wants to make provisions during the year 31-03-2017 in the following manner:

Total value of inventory ₹ 3 crores.

Provision required based on 12 months ₹ 8 lakhs.

Provision required based on technical evaluation ₹ 7.50 lakhs.

Does this amount to change in accounting policy?

Can the company change the method of provision?

Answer

Basis of provisioning whether on no issues or on technical evaluation is the basis of making estimates and cannot be considered as Accounting Policy. As per AS 5, due to 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. 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 basis of change in provisioning is a guideline and the better way of estimating the provision for non-moving inventory on account of change. Hence, it is not a change in accounting policy. Accounting policy is the valuation of inventory on cost or on net realizable value or on lower of cost or net realizable value. Any interchange of this valuation base would have constituted change in accounting policy.

Further, the company should be able to demonstrate satisfactorily that having regard to circumstances provision made on the basis of technical evaluation provides more satisfactory results than provision based on 12 months' issue. If that is the case, then the company can change the method of provision.

Accounting Standard 7

Question 26

Explain the provisions relating to combining of construction contracts.

Answer

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

(a) separate proposals have been submitted for each asset;

(b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and

(c) the costs and revenues of each asset can be identified.

A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

(a) the group of contracts is negotiated as a single package;

(b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and

(c) the contracts are performed concurrently or in a continuous sequence.

Question 27

Sagar Limited belongs to the engineering industry. The Chief Accountant has prepared the draft accounts for the year ended 31.03.2017. You are required to advise the company on the following items from the viewpoint of finalization of accounts, taking note of the mandatory accounting standards.

The company undertook a contract for building a crane for ₹ 10 lakhs. As on 31.03.2017 it incurred a cost of ₹ 1.5 lakhs and expects that there will be ₹ 9 lakhs more for completing the crane. It has received so far ₹ 1 lakh as progress payment.

Answer

Para 21 of AS 7 (Revised) 'Construction Contracts' provides that when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively with reference to the stage of completion of the contract activity at the reporting date.

Para 35 of AS 7 states that when it is probable that total contract cost will exceed total contract revenue, the expected losses should be recognized as an expense irrespective of:

a. Whether or not work has commenced

b. Stage of completion of contract

c. The amount of profit on other contracts which are not treated as a single contract

Thus, when Estimated Contract Costs > Total Contract Revenue

Expected Loss = **Work Certified + Work uncertified + Estimated cost to complete the project - Total value of contract**

Thus, in the given case, the foreseeable loss of ₹ 50,000 (expected cost ₹ 10.5 lakhs less contract revenue ₹ 10 lakhs) should be recognized as an expense in the year ended 31st March, 2017.

The following disclosures should also be given in the financial statements:

(a) the amount of contract revenue recognized as revenue in the period;

(b) the aggregate amount of costs incurred and loss recognized upto the reporting date;

(c) amount of advances received;

(d) amount of retentions; and

(e) gross amount due from/due to customers amount*

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* Amount due from/to customers = contract costs + Recognised profits – Recognised losses – Progress billings = ₹ 1.5 + Nil – ₹ 0.5 – ₹ 1.0 = Nil.

Question 28

Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional ₹ 2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily.

Is X correct in his proposal? Discuss.

Answer

According to para 14 of AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably. In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract.

Question 29

Jain Construction Co. Ltd. undertook a contract on 1st January, 2017 to construct a building for ₹ 80 lakhs. The company found on 31st March, 2017 that it had already spent ₹ 58,50,000 on the construction. Prudent estimate of additional cost for completion was ₹ 31,50,000.

What amount should be charged to revenue and what amount of contract value to be recognized as turnover in the final accounts for the year ended 31st March 2017 as per provisions of AS 7 (revised)?

Answer

	₹
Cost incurred till 31st March, 2017	58,50,000
Prudent estimate of additional cost for completion	31,50,000
Total cost of construction	90,00,000
Less: Contract price	(80,00,000)
Total foreseeable loss	10,00,000

As per para 35 of AS 7 (Revised) 'Construction Contracts' when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

Accordingly, the loss of ₹ 10,00,000 is required to be recognized as an expense in the year 2016-2017.

Also as per para 21 of the said standard when the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date.

Accordingly,

$$\text{Contract work in progress} = \frac{58,50,000 \times 100}{90,00,000} = 65\%$$

Proportion of total contract value to be recognized as turnover

= 65% of ₹ 80,00,000 = ₹ 52,00,000

Question 30

On 1st December, 2016, "Sampath" Construction Company Limited undertook a contract to construct a building for ₹ 108 lakhs. On 31st March, 2017 the company found that it had already spent ₹ 83.99 lakhs on the construction. A prudent estimate of additional cost for completion was ₹ 36.01 lakhs.

What is the provision for foreseeable loss, which must be made in the Final Accounts for the year ended 31st March, 2017 based on AS 7 "Accounting for Construction Contracts"?

Answer

Calculation of foreseeable loss for the year ended 31st March, 2017 (as per AS 7 "Construction Contracts")

	(₹ in lakhs)
Cost incurred till 31st March, 2017	83.99
Prudent estimate of additional cost for completion	36.01
Total cost of construction	120.00
Less: Contract price	(108.00)
Foreseeable loss	12.00

According to para 35 of AS 7 (Revised 2002) "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue; the expected loss should be recognized as an expense immediately. Therefore, amount of ₹ 12 lakhs is required to be provided for in the books of Sampath Construction Company for the year ended 31st March, 2017.

Question 31

PRZ & Sons Ltd. are Heavy Engineering contractors specializing in construction of dams. From the records of the company, the following data is available pertaining to year ended 31st March, 2017. Using this data and applying the relevant Accounting Standard you are required to:

(i) Compute the amount of profit/loss for the year ended 31st March, 2017.

(ii) Arrive at the contract work in progress as at the end of financial year 2016-17.

(iii) Determine the amount of revenue to be recognized out of the total contract value.

(iv) Work out the amount due from/to customers as at year end.

(v) List down relevant disclosures with figures as per relevant Account Standard

	(₹ crore)
Total Contract Price	*2,400*
Work Certified	*1,250*
Work pending certification	*250*
Estimated further cost to completion	*1,750*
Stage wise payments received	*1,100*
Progress payments in pipe line	*300*

Answer

(i)	**Calculation of profit/ loss for the year ended 31st March, 2017**	*(₹ in crores)*
	Total estimated cost of construction (1,250 + 250 + 1,750)	3,250
	Less: Total contract price	(2,400)
	Total foreseeable loss to be recognized as expense	850

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

(ii)	**Contract work-in-progress i.e. cost incurred to date**	*(₹ in crores)*
	Work certified	1,250
	Work not certified	250
		1,500

(iii) Proportion of total contract value recognised as revenue

Percentage of completion of contract to total estimated cost of construction

= (1,500 / 3,250)×100 = 46.15%

Revenue to be recognized till date = 46.15% of ₹ 2,400 crores = ₹ 1,107.60 crores.

(iv) Amount due from / to customers = Contract costs + Recognised profits – Recognised losses – (Progress payments received + Progress payments to be received)

= ₹ [1,500 + Nil – 850 – (1100 + 300)] crores

= ₹ [1,500 – 850 – 1,400] crores

Amount due to customers (shown as liability) = ₹ 750 crores.

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

	₹ in crores
Contract revenue till 31st March, 2017	1,107.60
Contract expenses till 31st March, 2017	1,500.00
Recognized losses for the year 31st March, 2017	(850)
Progress billings ₹ (1,100 + 300)	1,400
Progress (billed but not received from contractee)	300
Gross amount due to customers	750

Accounting Standard 9

Question 32

Write short note on Effect of Uncertainties on Revenue Recognition.

Answer

Effect of Uncertainties on Revenue Recognition

Para 9 of AS 9 on "Revenue Recognition" deals with the effect of uncertainties on Revenue Recognition. The para states:

1. Recognition of revenue requires that revenue is measurable and at the time of sale or the rendering of the service it would not be unreasonable to expect ultimate collection.
2. Where the ability to assess the ultimate collection with reasonable certainty is lacking at the time of raising any claim, e.g., for escalation of price, export incentives, interest etc. revenue recognition is postponed to the extent of uncertainty involved. In such cases, it may be appropriate to recognise, revenue only when it is reasonably certain that the ultimate collection will be made. When there is uncertainty as to ultimate collection, revenue is recognised at the time of sale or rendering of service even though payments are made by instalments.
3. When the uncertainty relating to collectability arises subsequent to the time of sale or rendering of the service, it is more appropriate to make a separate provision to reflect the uncertainty rather than to adjust the amount of revenue originally recorded.
4. An essential criterion for the recognition of revenue is that the consideration receivable for the sale of goods, the rendering of services or from the use by others of enterprise resources is reasonably determinable. When such consideration is not determinable within reasonable limits; the recognition of revenue is postponed.

5. When recognition of revenue is postponed due to the effect of uncertainties, it is considered as revenue of the period in which it is properly recognized.

Question 33

SM company has taken a Transit Insurance Policy. Suddenly in the year 2016-2017 the percentage of accident has gone up to 7% and the company wants to recognize insurance claim as revenue in 2016-2017 in accordance with relevant Accounting Standards. Do you agree? Explain in brief, as per the relevant Accounting Standards.

Answer

When to Recognize Revenue:

- Revenue recognition is mainly concerned with the **timing of recognition of revenue** in the profit and loss account.
- Where **there is no uncertainty** as to **ultimate collection**, revenue is **recognised at the time of sale** or **rendering of services**, as the case may be even though payments are made by installments.
- The amount of revenue is usually determined by agreement between the parties to the transaction

It may be appropriate to recognize revenue only when it is reasonably certain that the ultimate collection will be made.

In the given case, SM company wants to suddenly recognize Insurance claim because it has increased over the previous year. **But, there are uncertainties involved in the settlement of the claim.** Also, the claim does not seem to be in the course of ordinary activity of the company.

Hence, SM company is not advised to recognize the Insurance claim as revenue.

Question 34

Bottom Ltd. entered into a sale deed for its immovable property before the end of the year. But registration was done with registrar subsequent to Balance Sheet date. But before finalization, is it possible to recognize the sale and the gain at the Balance Sheet date? Give your view with reasons.

Answer

Yes, both sales and gain of Bottom Ltd. should be recognized. In accordance with AS 9, at the Balance Sheet date and what was pending was merely a formality to register the deed. It is clear that significant risk and rewards of ownership had passed before the balance sheet date. Further the registration post the balance sheet date confirms the condition of sale at the balance sheet date as per AS 4.

Question 35

Victory Ltd. purchased goods on credit from Lucky Ltd. for ₹ 250 crores for export. The export order was cancelled. Victory Ltd. decided to sell the same goods in the local market with a price discount. Lucky Ltd. was requested to offer a price discount of 15%. The Chief Accountant of Lucky Ltd. wants to adjust the sales figure to the extent of the discount requested by Victory Ltd. Discuss whether this treatment is justified.

Answer

Lucky Ltd. had sold goods to Victory Ltd on credit worth for ₹ 250 crores and the sale was completed in all respects. Victory Ltd.'s decision to sell the same in the domestic market at a discount does not affect the amount recorded as sales by Lucky Ltd. The price discount of 15% offered by Lucky Ltd. after request of Victory Ltd. was not in the nature of a discount given during the ordinary course of trade because otherwise the same would have been given at the time of sale itself. Now, as far Lucky Ltd is concerned, there appears to be an uncertainty relating to the collectability of the debt, which has arisen subsequent to the time of sale therefore, it would be appropriate to make a separate provision to reflect the uncertainty relating to collectability rather than to adjust the amount of revenue originally recorded. Therefore, such discount should be written off to the profit and loss account and not shown as deduction from the sales figure.

Question 36

Golden Eagle Ltd., has been successful jewellers for the past 100 years and sales are against cash only. The company diversified into apparels. A young senior executive was put in charge of Apparels business and sales increased 5 times. One of the conditions for sales is that dealers can return the unsold stocks within one month of the end of season. Sales return for the year was 25% of sales. Suggest a suitable Revenue Recognition Policy, with reference to AS 9.

Answer

As per AS 9 "Revenue recognition", revenue recognition is mainly concerned with the timing of recognition of revenue in statement of profit and loss of an enterprise. The amount of revenue arising on a transaction is usually determined by the agreement between the parties involved in the transaction. When uncertainties exist regarding the determination of the amount, or its associated costs, these uncertainties may influence the timing of revenue recognition.

Effect of Uncertainty- In the case of the jewellery business the company is selling for cash and returns are negligible. Hence, revenue can be recognized on sales. On the other hand, in Apparels Industry, the dealers have a right to return the unsold goods within one month of the end of the season. In this case, the company is bearing the risk of sales return and therefore, the company should not recognize the revenue to the extent of 25% of its sales. The company may disclose suitable revenue recognition policy in its financial statements separately for both Jewellery and Apparels business.

Question 37

A company is engaged in the business of ship building and ship repair. On completion of the repair work, a work completion certificate is prepared and countersigned by ship owner (customer). Subsequently, invoice is prepared based on the work completion certificate describing the nature of work done together with the rate and the amount. Customer scrutinizes the invoice and any variation is informed to the company. Negotiations take place between the company and the customer. Negotiations may result in a deduction being allowed from the invoiced amount either as a lumpsum or as a percentage of the invoiced amount. The accounting treatment followed by the company is as follows:

(i) When the invoice is raised, the customer's account is debited and ship repair income account is credited with the invoiced amount.

(ii) Deduction, if any, arrived after negotiation is treated as trade discount by debiting the ship repair income account.

(iii) At the close of the year, negotiation in respect of certain invoices had not been completed. In such cases, based on past experience, a provision for anticipated loss is created by debiting the Profit and Loss account. The provision is disclosed in Balance Sheet.

Following two aspects are settled in the negotiations:

(i) Errors in billing arising on account of variation between the quantities as per work completion certificate and invoice and other clerical errors in preparing the invoice.

(ii) Disagreement between the company and customer about the rate/cost on which prior agreement has not been reached between them.

Comment:

(i) Whether the accounting treatment of deduction as trade discount is correct? If not, state the correct accounting treatment.

(ii) Whether the disclosure of the provision for anticipated loss in Balance Sheet is correct; if not, statement correct accounting treatment.

Answer

(i) As per AS 9 "Revenue Recognition", revenue is recognized at the time when the invoice is raised to the customers; however, the treatment of deduction as trade discount is not as per AS 9. Considering the treatment prescribed by AS 4 "Contingencies and Events occurring after the Balance Sheet Date", the correct treatment of the difference between the invoice amount and finally settled amount should be under:

The adjustment of the difference between the invoiced amount and the amount finally settled against "Ship Repair Income" account is in order. Events occurring up to the date of approval of the accounts by the Approving Authority should be taken into consideration in determining the amount of adjustment to be made in this regard. The description of the difference as "trade discount" is not appropriate.

(ii) In respect of ship repair jobs for which negotiations between the ship owners and the company are not over, the accounting treatment is not appropriate. Instead, the amount of difference between the invoiced amount and the amount likely to be finally settled (as estimated on the basis of past experience) should be adjusted in the "Ship Repair Income" by a corresponding credit to the accounts of the respective ship owners. Consequently, the figure of trade receivable included in the balance sheet would be net of adjustment for such difference. In other words, the amount of the difference would be neither shown under the head provisions nor shown as a deduction from the trade receivables in the balance sheet.

Question 38

Prima Ltd. sold goods worth ₹ 50,000 to M/s Y and Company. M/s Y and Co. asked for discount of ₹ 8,000 which was agreed by Prima Ltd. the sale was affected and goods were dispatched. After receiving goods worth ₹ 7,000 was found defective which they returned immediately. They made the payment of ₹ 35,000 to Prima Ltd. Accountant booked the sales for ₹ 35,000. Please discuss.

Answer

As per Para 4.1 of AS 9 "Revenue Recognition", revenue is the gross inflow of cash, receivables or other consideration arising in the course of the ordinary activities of an enterprise from the sale of goods, from the rendering of services, and from the use by others of enterprise resources yielding interest, royalties and dividends.

In the given case, Prima Ltd. should record the sales at gross value of ₹ 50,000. Discount of ₹ 8,000 in price and goods returned worth ₹ 7,000 are to be adjusted by suitable provisions. Prime Ltd. might have sent the credit note of ₹ 15,000 to M/s Y & Co. to account for these adjustments. The contention of the accountant to book the sales for ₹ 35,000 is not correct.

Question 39

Moon Ltd. entered into agreement with Sun Ltd. for sale of goods of ₹ 8 lakhs at a profit of 20% on cost. The sale transaction took place on 1st February, 2016. On the same day Sun Ltd. entered into another agreement with Moon Ltd. to resell the same goods at ₹ 10.80 lakhs on 1st August, 2016. State the treatment of this transaction in the financial statements of Moon Ltd. as on 31.03.14. The pre-determined re-selling price covers the holding cost of Sun Ltd. Give the Journal Entries as on 31.03.14 in the books of Moon Ltd.

Answer

In the given case, Moon Ltd. concurrently agreed to repurchase the same goods from Sun Ltd. on 1st Feb., 2016. Also the re-selling price is pre-determined and covers purchasing and holding costs of Sun Ltd. Hence, the transaction between Moon Ltd. and Sun Ltd. on 1st Feb., 2016 should be accounted for as financing rather than sale. The resulting cash flow of ₹ 9.60 lakhs received by Moon Ltd., cannot be considered as revenue as per AS 9 "Revenue Recognition".

Journal Entries in the books of Moon Ltd.

				(₹ in lakhs)
1.02.14	Bank Account	Dr.	9.60	
	To Advance from Sun Ltd*.			9.60
	(Being advance received from Sun Ltd amounting [₹ 8 lakhs + 20% of ₹ 8 lakhs= 9.60 lakhs] under sale and re-purchase agreement)			
31.03.14	Financing Charges Account	Dr.	0.40	
	To Sun Ltd.			0.40
	(Financing charges for 2 months at ₹ 1.20 lakhs [10.80 – 9.60] i.e. 1.2 lakhs x 2/6)			
31.03.14	Profit and Loss Account	Dr.	0.40	
	To Financing Charges Account			0.40
	(Being amount of finance charges transferred to P& L Account)			

Accounting Standard 10

Question 40

XYZ Ltd. has acquired a heavy road transporter at a cost of ₹ 1,00,000 (with no breakdown of the component parts). The estimated useful life is 10 years. At the end of the sixth year, the power train (one of its component) requires replacement, as further maintenance is uneconomical due to the off-road time required. The remainder of the vehicle is perfectly roadworthy and is expected to last for the next four years. The cost of a new power train is ₹ 45,000.

Can the cost of the new power train be recognized as an asset, and, if so, what treatment should be used?

Answer

The new power train will produce economic benefits to XYZ Ltd., and the cost is measurable. Hence the item should be recognized as an asset as per AS 10 (Revised) as the recognition criteria is satisfied.

* The balance of Sun Ltd. account will be disclosed as an advance under the heading liabilities in the balance sheet of Moon Ltd. as on 31st March, 2016.

The original invoice for the transporter did not specify the cost of the power train. However, its cost of the replacement is ₹ 45,000 which can be used as an indication (usually by discounting factor) of the likely cost, six years previously.

If an appropriate discount rate is 5% per annum, ₹ 45,000 discounted back six years amounts to ₹ 33,570 (45,000 x 0.746), which would be written out of the asset records.

The cost of the new power train, ₹ 45,000, would be added to the asset record, resulting in a new asset cost of ₹ 1,11,430 (₹ 1,00,000 – ₹ 33,570 + ₹ 45,000).

Question 41

ABC Ltd. is installing a new plant at its production facility. It has incurred these costs:

1.	Cost of the plant (cost per supplier's invoice plus taxes)	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants used for advice on the acquisition of the plant	₹ 7,00,000
5.	Interest charges paid to supplier of plant for deferred credit	₹ 2,00,000
6.	Estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
7.	Operating losses before commercial production	₹ 4,00,000

Please advise ABC Ltd. on the costs that can be capitalized in accordance with AS 10 (Revised).

Answer

According to AS 10 (Revised), these costs can be capitalized:

1.	Cost of the plant	₹ 25,00,000
2.	Initial delivery and handling costs	₹ 2,00,000
3.	Cost of site preparation	₹ 6,00,000
4.	Consultants' fees	₹ 7,00,000
5.	Estimated dismantling costs to be incurred after 7 years	₹ 3,00,000
		₹ 43,00,000

Note: Interest charges paid on "Deferred credit terms" to the supplier of the plant (not a qualifying asset) of ₹ 2,00,000 and operating losses before commercial production amounting to ₹ 4,00,000 are not regarded as directly attributable costs and thus cannot be capitalized. They should be written off to the Statement of Profit and Loss in the period they are incurred.

Question 42

A Ltd. has an item of plant with an initial cost of ₹ 1,00,000. At the date of revaluation, accumulated depreciation amounted to ₹ 55,000. The fair value of the asset, by reference to transactions in similar assets, is assessed to be ₹ 65,000.

Pass Journal Entries with regard to Revaluation?

Answer

The entries to be passed would be:

		₹	₹
Accumulated depreciation	Dr.	55,000	
To Asset A/c			55,000
(Being elimination of accumulated depreciation against the cost of the asset)			
Asset A/c	Dr	20,000	
To Revaluation Surplus			20,000
(Being increase of net asset value to Fair value)			

Note: The net result is that the asset has a carrying amount of ₹ 65,000 [1,00,000 – 55,000 + 20,000.]

Question 43

B Ltd. owns an asset with an original cost of ₹ 2,00,000. On acquisition, management determined that the useful life was 10 years and the residual value would be ₹ 20,000. The asset is now 8 years old, and during this time there have been no revisions to the assessed residual value.

At the end of year 8, management has reviewed the useful life and residual value and has determined that the useful life can be extended to 12 years in view of the maintenance program adopted by the company. As a result, the residual value will reduce to ₹ 10,000.

How would the above changes in estimates be made by B Ltd.?

Answer

The above changes in estimates would be effected in the following manner:

The asset has a carrying amount of ₹ 56,000 at the end of year 8 [₹ 2,00,000 – ₹ 1,44,000] i.e. Accumulated Depreciation.

Accumulated depreciation is calculated as

Depreciable amount {Cost less residual value} = ₹ 2,00,000 – ₹ 20,000 = ₹ 1,80,000.

Annual depreciation = Depreciable amount / Useful life = 1,80,000 / 10 = ₹ 18,000.

Accumulated depreciation = 18,000 × No. of years (8) = ₹ 1,44,000.

Revision of the useful life to 12 years results in a remaining useful life of 4 years (12 – 8).

The revised depreciable amount is ₹ 46,000. (56,000 – 10,000)

Thus, depreciation should be charged in future at ₹ 11,500 per annum (₹ 46,000/4 years).

Question 44

Determine if the following costs can be added to the invoiced purchase price and included in the initial recognition of the cost of the asset:

1. *Consultants fees for choosing the new asset*
2. *A trade discount received of 5% of the purchase price of the asset*
3. *A discount received for paying the invoice within 90 days*
4. *Interest paid on a short term loan taken to provide the necessary cash for payment of the purchase price*
5. *Import duties paid*
6. *Shipping costs and cost of road transport*
7. *Insurance for the shipping*
8. *An economic development rebate from the state*
9. *VAT paid on the purchase*
10. *Cost of laying a new concrete slab and installing special rubber mounted footings for the new press in order to reduce vibration during use*
11. *Hire of a crane to transfer the press from the vehicles into the factory*
12. *Costs associated with removing a section of the factory roof to allow the machine to be dropped into place and subsequently refitting the roof*
13. *Cost of installing soundproofing in the roof at the same time in order to provide protection for workers in other parts of the factory building*
14. *Professional fees charged by consulting engineer for overseeing the installation process*
15. *Electricians fees for connecting the press to the power supply*
16. *A portion of the operating costs (salaries, office expenses) of the purchasing department*
17. *Costs of materials (papers and inks) used in calibrating the machine and setting it up for operation*
18. *Costs of training the operators of the new machine*
19. *A portion of the inefficiencies in production for the first month of use while the operators became comfortable with using the machine*

Answer

Included in Cost:

Point no. 2,5,6,7,8,10,11,12,14,15 and 17

Excluded from Cost:

Point no. 1,3,4,9,13,16,18 and 19

Question 45

A Ltd. has carried out certain works on various machines in their engineering plant, which manufactures high quality metal patterns and templates for use in industry.

Determine in each case whether the costs of the improvements can be added to the existing carrying value of the assets concerned?

1. *The cost of an annual machine overhaul which will maintain the originally assessed standard of performance of the machine for the coming 12 months.*
2. *The cost of repairs to a press machine, which was damaged by the emergency services while trying to extricate the arm of a worker who had become trapped in the press.*
3. *Modifications to a cutting machine which will increase its rate of output from 500 to 560 patterns per shift.*
4. *Modifications to a lathe which will replace the current water cooling system with an oil-based system, thereby extending the life of the lathe by a forecast 2 years.*
5. *The upgrading of a cutting machine with new software which will improve the accuracy of its measurement and cutting tolerances by a number of microns, thereby raising the quality of output.*
6. *Alterations to a production line which will allow automatic feeding from a machine to the next one in the production process, thereby removing the need for an employee to manually load the second machine.*

Answer

Point 1: No. This may not be capitalized as subsequent expenditure, since it merely maintains the originally assessed standard of performance of the asset.

Point 2: Yes. An impairment loss should have been recognized when the damage occurred and any insurance payment received as compensation should have been recognized as income in the Statement of Profit and Loss when received.

When expenditure is incurred to restore the asset, such expenditure is added to the carrying amount of the asset to the extent that it is probable that future economic benefits will flow to the enterprise.

Point 3: Yes. The cost of such modifications may be added to the carrying amount of the asset.

Point 4: Yes. Such costs may be capitalized.

Point 5: Yes. Such costs may be capitalized.

Point 6: Yes. Such costs may be capitalized.

Question 46

An entity bought a plot of land for development of office buildings. Development of the land was scheduled into six phases. The land scheduled for development in phases five and six was leased to another entity on a short-term basis as a parking lot for heavy vehicles.

What is the treatment of rental income from car parking lot?

Answer

Rental income from the car park lease is recognized in the Statement of Profit and Loss for the period.

The car park activity is incidental to the entity`s principal activity of property development. Operations that are incidental to the construction or development of property, plant and equipment are not necessary to bring the asset to its working condition for its intended use.

The income and related expenses of incidental operations are recognized in the Statement of Profit and Loss for the period.

Question 47

An entity acquires the right to use an underground cave for gas storage purposes for a period of 50 years. The cave is filled with gas, but a substantial part of that gas will only be used to keep the cave under pressure in order to be able to get gas out of the cave. It is not possible to distinguish the gas that will be used to keep the cave under pressure and the rest of the gas.

Evaluate whether AS 10 would apply or AS 2?

Answer

The total volume of gas must be virtually split into

(i) Gas held for sale, and

(ii) Gas held to keep the cave under pressure.

The former must be accounted for under AS 2 as Inventories. The latter must be accounted for as PPE under AS 10 and depreciated over the period the cave is expected to be used.

Question 48

An entity operates an oil refining plant. For the refining process to take place, the plant must contain a certain minimum quantity of oil. This can only be taken out once the plant is abandoned and would then be polluted to such an extent that the plant's value is significantly reduced.

Evaluate whether AS 10 would apply or AS 2?

Answer

The part of the crude that is necessary to operate the plant and cannot be recouped (or can be recouped but would then be significantly impaired), even when the plant is abandoned, should be considered as an item of PPE under AS 10 and amortized over the life of the plant.

Accounting Standard 11

Question 49

Distinguish between Integral foreign operation and Non-integral foreign operation.

Answer

	Integral Foreign Operation	Non-Integral Foreign Operation (NFO)
Meaning	It is a foreign operation, the activities of which are an integral part of those of the reporting enterprise.	It is a foreign operation that is not an integral Foreign Operation.
Business	The business of IFO is carried on as if it were an extension of the reporting enterprise's operations.	The business of NFO is carried on in a substantially independent manner by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowings, in its local currency.
Example	Sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.	Production in a foreign country out of resources available in such nation independent of the reporting enterprise.
Currencies operated	Generally, IFO carries on business in a single foreign currency, i.e. of the country where it is located.	NFO business may also enter into transactions in foreign currencies, including transactions in the reporting currency.
Cash flows from operations	Cash flows from operations of the reporting enterprise are directly and immediately affected by a change in the exchange rate between the reporting currency and the currency in the country of IFO.	Change in the exchange rate between the reporting currency and the local currency, has little or no direct effect on the present and future Cash Flows from Operations of either the NFO or the reporting enterprise.
Effect of Change in Exchange Rate	Change in the exchange rate affects the individual monetary items held by the IFO rather than the reporting enterprise's Net Investment in the IFO.	Change in the exchange rate affects the reporting enterprise's net investment in the NFO rather than the individual monetary and non-monetary items held by that NFO.

Question 50

A company had imported raw materials worth US Dollars 6,00,000 on 5th January, 2017, when the exchange rate was ₹ 43 per US Dollar. The company had recorded the transaction in the *books at the above mentioned rate. The payment for the import transaction was made on 5th April, 2017 when the exchange rate was ₹ 47 per US Dollar. However, on 31st March, 2017, the rate of exchange was ₹ 48 per US Dollar. The company passed an entry on 31st March, 2017 adjusting the cost of raw materials consumed for the difference between ₹ 47 and ₹ 43 per US Dollar.*

In the background of the relevant accounting standard, is the company's accounting treatment correct? Discuss.

Answer

As per AS 11 (revised 2003), 'The Effects of Changes in Foreign Exchange Rates', monetary items denominated in a foreign currency should be reported using the closing rate at each balance sheet date. The effect of exchange difference should be taken into profit and loss account. Trade payables is a monetary item, hence should be valued at the closing rate i.e, ₹ 48 at 31st March, 2017 irrespective of the payment for the same subsequently at lower rate in the next financial year. The difference of ₹ 5 (₹ 48-₹ 43) per US dollar should be shown as an exchange loss in the profit and loss account for the year ended 31st March, 2017 and is not to be adjusted against the cost of raw- materials. In the subsequent year, the company would record an exchange gain of ₹ 1 per US dollar, i.e., the difference between ₹ 48 and ₹ 47 per US dollar. Hence, the accounting treatment adopted by the company is incorrect.

Question 51

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 recognised in the books.

Answer

It is apparent from the facts given in the question that Mr. A entered into forward exchange contract for speculation purpose*.According to paragraphs 38 and 39 of AS 11(Revised) 'The Effects of Changes in Foreign Exchange Rates', gain or loss on forward exchange contracts intended for trading or speculation purpose 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 and the premium or discount on the forward exchange contract is ignored and not recognised separately. In recording such contract, 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.

*The forward contract is sold before its due date, hence considered as speculative.

Thus, the premium on contract i.e., the difference between the contract rate and the spot rate amounting ₹ 8,000 [US $ 1,00,000 x (₹ 47.10 – ₹ 47.02)] will be ignored and not be recorded in the books. However, the profit on contract i.e. the difference between the sale rate and contract rate amounting ₹ 8,000 [US$ 1,00,000 x 0.08* (₹ 47.18 – ₹ 47.10)] will be recognized in the books of Mr. A on 31st January.

Illustration 52

Opportunity Ltd. purchased an equipment costing ₹ 24,00,000 lakhs on 1.4.2015 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 1.4.2015 and 31.3.2016 respectively. First installment was paid on 31.3.2016. 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 x (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

*The current market value of the forward contract on 31st December has not been given in the question. Therefore, no gain or loss can be recognised in the books on 31st December. The profit amounting ₹ 8,000 will be recognised in the year of sale only.

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 31.3.2016	₹ 1,00,000
Total cost on the reporting date	₹ 25,00,000

Accounting Standard 12

Question 53

Write short note on 'Treatment of refund of Government grants'.

Answer

As per Para 11 of AS 12 "Accounting for Government Grants", government grant that becomes refundable should be treated as an extraordinary item. The amount refundable in respect of a government grant related to revenue is applied first against any unamortized deferred credit remaining in respect of the grant. To the extent that the amount refundable exceeds any such deferred credit, or where no deferred credit exists, the amount is charged immediately to profit and loss statement. The amount refundable in respect of a government grant related to a specific fixed asset is recorded by increasing the book value of the asset or by reducing the capital reserve or the deferred income balance, as appropriate, by the amount refundable. 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. 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.

Accounting Standard 13

Question 54

Write short note on Accounting for investment by a holding company in subsidiaries.

Answer

Investments by a holding company in the shares of its subsidiary company are normally considered as long term investments. Indian holding companies show investment in subsidiary just like any other investment and generally classify it as trade investment. As per AS 13 'Accounting for Investments', investments are classified as long term and current investments. A current investment is an investment that by its nature is readily realizable and is intended to be held for more than one year from the date of acquisition. A long term investment is one that is not a current one.

Costs of investment include besides acquisition charges, expenses such as brokerage, fees and duties. If an investment is acquired wholly or partly by an issue of shares or other securities, the acquisition cost is determined by taking the fair value of the shares/securities issued. If an investment were to be acquired in exchange – part or whole – for another asset, the acquisition cost of the investment is determined with reference to the value of the other asset exchanged. Dividends received out of income earned by a subsidiary before the acquisition of the shares by the holding company and not treated as income but treated as recovery of cost of the assets (investment made in the subsidiary). The carrying cost for current investment is the lower of cost or fair/market value whereas investment in the shares of the subsidiary (treated as long term) is carried normally at cost.

Question 55

'Suram' Ltd. wants to re-classify its Investment in accordance with AS 13. Decide on the treatment to be given in each of the following cases:

(1) A portion of Current Investments purchased for ₹ 20 lakhs to be reclassified as long-term Investments, as the company has decided to retain them. The market value as on the date of Balance Sheet was ₹ 25 lakhs.

(2) Another portion of Current Investments purchased for ₹ 15 lakhs has to be re classified as Long-term Investments. The market value of these investments as on the date of Balance Sheet was ₹ 6.5 lakhs.

(3) Certain Long-term Investments no longer considered for holding purposes have to be re-classified as Current Investments. The original cost of these was ₹ 18 lakhs but they had been written down to ₹ 12 lakhs to recognize permanent decline as per AS 13.

Answer

As per Para 24 of AS 13 'Accounting for Investments', where investments are reclassified from current to long-term, transfers are made at the lower of cost and fair value at the date of transfer.

In the first case, the market value* of the investment is ₹ 25 lakhs, which is higher than its cost i.e. ₹ 20 lakhs. Therefore, the transfer to long term investments should be carried at cost i.e. ₹ 20 lakhs.

In the second case, the market value* of the investment is ₹ 6.5 lakhs, which is lower than its cost i.e. ₹ 15 lakhs. Therefore, the transfer to long term investments should be carried in the books at the market value i.e. ₹ 6.5 lakhs. The loss of ₹ 8.5 lakhs should be charged to profit and loss account.

As per para 23 of AS 13, where long-term investments are re-classified as current investments, transfers are made at the lower of cost and carrying amount at the date of transfer.

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* It is assumed that the market value has been determined in an arm's length transaction between knowledgeable and willing buyer and seller.

In the third case, the book value of the investment is ₹ 12 lakhs, which is lower than its cost i.e. ₹ 18 lakhs. Here, the transfer should be at carrying amount and hence this re-classified current investment should be carried at ₹ 12 lakhs.

Question 56

X Ltd. on 1-1-2017 had made an investment of ₹ 600 lakhs in the equity shares of Y Ltd. of which 50% is made in the long term category and the rest as temporary investment. The realizable value of all such investment on 31-3-2017 became ₹ 200 lakhs as Y Ltd. lost a case of copyright. How will you recognize the reduction in financial statements for the year ended on 31-3-2017.

Answer

X limited invested ₹ 600 lakhs in the equity shares of Y Ltd. Out of the same, the company intends to hold 50% shares for long term period i.e. ₹ 300 lakhs and remaining as temporary (current) investment i.e. ₹ 300 lakhs. Irrespective of the fact that investment has been held by X Limited only for 3 months (from 1.1.2017 to 31.3.2017), AS 13 lays emphasis on intention of the investor to classify the investment as current or long term even though the long term investment may be readily marketable.

In the given situation, the realizable value of all such investments on 31.3.2017 became ₹ 200 lakhs i.e. ₹ 100 lakhs in respect of current investment and ₹ 100 lakhs in respect of long term investment.

As per AS 13, 'Accounting for Investment', the carrying amount for current investments is the lower of cost and fair value. In respect of current investments for which an active market exists, market value generally provides the best evidence of fair value.

Accordingly, the carrying value of investment held as temporary investment should be shown at realizable value i.e. at ₹ 100 lakhs. The reduction of ₹ 200 lakhs in the carrying value of current investment will be included in the profit and loss account.

Standard further states that long-term investments are usually carried at cost. However, when there is a decline, other than temporary, in the value of long term investment, the carrying amount is reduced to recognise the decline.

Here, Y Limited lost a case of copyright which drastically reduced the realisable value of its shares to one third which is quiet a substantial figure. Losing the case of copyright may affect the business and the performance of the company in long run. Accordingly, it will be appropriate to reduce the carrying amount of long term investment by ₹ 200 lakhs and shown the investments at ₹ 100 lakhs, considering the downfall in the value of shares as decline other than temporary. The reduction of ₹ 200 lakhs in the carrying value of long term investment will be included in the profit and loss account.

Alternatively, for treatment of long term investment, if one assumes that the decline in the value of long term investment is temporary and Y Limited will overcome this downfall in short period by filing a case against this decision of government, with strong arguments. In such a case, long term investment will be shown at cost.

Question 57

Anischit Finance Ltd. is a non-banking finance company. It makes available to you the costs and market price of various investments held by it as on 31.3.2017:

(Figures in ₹ lakhs)

Scripts:		*Cost*	*Market Price*
A.	*Equity Shares-*		
	A	*60.00*	*61.20*
	B	*31.50*	*24.00*
	C	*60.00*	*36.00*
	D	*60.00*	*120.00*
	E	*90.00*	*105.00*
	F	*75.00*	*90.00*
	G	*30.00*	*6.00*
B.	*Mutual funds-*		
	MF-1	*39.00*	*24.00*
	MF-2	*30.00*	*21.00*
	MF-3	*6.00*	*9.00*
C.	*Government securities-*		
	GV-1	*60.00*	*66.00*
	GV-2	*75.00*	*72.00*

(i) Can the company adjust depreciation of a particular item of investment within a category?

(ii) What should be the value of investments as on 31.3.2017?

(iii) Is it possible to off-set depreciation in investment in mutual funds against appreciation of the value of investment in equity shares and government securities?

Answer

(i) Quoted current investments for each category shall be valued at cost or market value, whichever is lower. For this purpose, the investments in each category shall be considered scrip-wise and the cost and market value aggregated for all investments in each category. If the aggregate market value for the category is less than the aggregate cost for that category, the net depreciation shall be provided for or charged to the profit and loss account. If the aggregate market value for the category exceeds the aggregate cost for the category, the net appreciation shall be ignored. Therefore, depreciation of a particular item of investments can be adjusted within the same category of investments.

(ii) Value of Investments as on 31.3.2017

Type of Investment	*Valuation Principle*	*Value ₹ in lakhs*
Equity Shares (Aggregated)	Lower of cost or market Value	406.50
Mutual Funds	NAV (Market value, assumed)	54.00
Government securities	Cost	135.00
		595.50

As per para 14 of AS 13 "Accounting for Investments", the carrying amount for current investments is the lower of cost and market price. Sometimes, the concern of an enterprise may be with the value of a category of related current investments and not with each individual investment, and accordingly, the investments may be computed at the lower of cost and market value computed category-wise.

(iii) Inter category adjustments of appreciation and depreciation in values of investments cannot be done. It is not possible to offset depreciation in investment in mutual funds against appreciation of the value of investments in equity shares and Government securities.

Accounting Standard 15

Question 58

What are the types of Employees benefits and what is the objective of Introduction of this Standard i.e. AS 15?

Answer

There are four types of employee benefits according to AS 15 (Revised 2005). They are:

(a) short-term employee benefits, such as wages, salaries and social security contributions (e.g., contribution to an insurance company by an employer to pay for medical care of its employees), paid annual leave, profit-sharing and bonuses (if payable within twelve months of the end of the period) and non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) post-employment benefits such as gratuity, pension, other retirement benefits, post-employment life insurance and post-employment medical care;

(c) other long-term employee benefits, including long-service leave or sabbatical leave, jubilee or other long-service benefits, long-term disability benefits and, if they are not payable wholly within twelve months after the end of the period, profit-sharing, bonuses and deferred compensation; and

(d) termination benefits.

Since each category identified in (a) to (d) above has different characteristics, this Statement establishes separate requirements for each category.

The objective of AS 15 is to prescribe the accounting and disclosure for employee benefits. The statement requires an enterprise to recognise:

(a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.

Question 59

A company has a scheme for payment of settlement allowance to retiring employees. Under the scheme, retiring employees are entitled to reimbursement of certain travel expenses for class they are entitled to as per company rule and to a lump-sum payment to cover expenses on food and stay during the travel. Alternatively, employees can claim a lump sum amount equal to one month pay last drawn.

The company's contentions in this matter are:

(i) Settlement allowance does not depend upon the length of service of employee. It is restricted to employee's eligibility under the Travel rule of the company or where option for lump-sum payment is exercised, equal to the last pay drawn.

(ii) Since it is not related to the length of service of the employees, it is accounted for on claim basis.

State whether the contentions of the company are correct as per relevant Accounting Standard. Give reasons in support of your answer.

Answer

The present case falls under the category of defined benefit scheme under Para 49 of AS 15 (Revised) "Employee Benefits". The said para encompasses cases where payment promised to be made to an employee at or near retirement presents significant difficulties in the determination of periodic charge to the statement of profit and loss. The contention of the Company that the settlement allowance will be accounted for on claim basis is not correct even if company's obligation under the scheme is uncertain and requires estimation. In estimating the obligation, assumptions may need to be made regarding future conditions and events, which are largely outside the company's control. Thus,

(1) Settlement allowance payable by the company is a defined retirement benefit, covered by AS 15 (Revised).

(2) A provision should be made every year in the accounts for the accruing liability on account of settlement allowance. The amount of provision should be calculated according to actuarial valuation.

(3) Where, however, the amount of provision so determined is not material, the company can follow some other method of accounting for settlement allowances.

Question 60

The following data apply to 'X' Ltd. defined benefit pension plan for the year ended 31.03.15, calculate the actual return on plan assets:

- Benefits paid	*2,00,000*
- Employer contribution	*2,80,000*
- Fair market value of plan assets on 31.03.15	*11,40,000*
- Fair market value of plan assets as on 31.03.14	*8,00,000*

Answer

		₹
Fair value of plan assets on 31.3.14		8,00,000
Add: Employer contribution		2,80,000
Less: Benefits paid		(2,00,000)
	(A)	8,80,000
Fair market value of plan assets at 31.3.15	(B)	11,40,000
Actual return on plan assets	(B-A)	2,60,000

Question 61

The fair value of plan assets of Anupam Ltd. was ₹ 2,00,000 in respect of employee benefit pension plan as on 1st April, 2016. On 30th September, 2016 the plan paid out benefits of ₹ 25,000 and received inward contributions of ₹ 55,000. On 31st March, 2017 the fair value of plan assets was ₹ 3,00,000. On 1st April, 2016 the company made the following estimates, based on its market studies and prevailing prices.

	%
Interest and dividend income (after tax) payable by fund	*10.25*
Realized gains on plan assets (after tax)	*3.00*
Fund administrative costs	*(3.00)*
Expected rate of return	*10.25*

Calculate the expected and actual returns on plan assets as on 31st March, 2017, as per AS 15.

Answer

Computation of Expected Returns on Plan Assets as on 31st March, 2017, as per AS 15

	₹
Return on opening value of plan assets of ₹ 2,00,000 (held for the year) @ 10.25%	20,500
Add: Return on net gain of ₹ 30,000 (i.e. ₹ 55,000 – ₹ 25,000) during the year i.e. held for six months @ 5% (equivalent to 10.25% annually, compounded every six months)	1,500
Expected return on plan assets as on 31st March, 2017	22,000

Computation of Actual Returns on Plan Assets as on 31st March, 2017, as per AS 15

	₹	₹
Fair value of Plan Assets as on 31st March, 2017		3,00,000
Less: Fair value of Plan Assets as on 1st April, 2016	(2,00,000)	
Add: Contribution received as on 30th September, 2016	55,000	(2,55,000)
		45,000
Add: Benefits paid as on 30th September, 2016		25,000
Actual returns on Plan Assets as on 31st March, 2017		70,000

Question 62

Kumar Ltd., is in engineering industry. The company received an actuarial valuation for the first time for its pension scheme which revealed a surplus of ₹ 6 lakhs. It wants to spread the same over the next 2 years by reducing the annual contribution to ₹ 2 lakhs instead of ₹ 5 lakhs. The average remaining life of the employee is estimated to be 6 years.

You are required to advise the company.

Answer

According to para 92 of AS 15 (Revised) "Employee Benefits", actuarial gains and losses should be recognized immediately in the statement of profit and loss as income or expense. Therefore, surplus of ₹ 6 lakhs in the pension scheme on its actuarial valuation is required to be credited to the profit and loss statement of the current year. Hence, Kumar Ltd. cannot spread the actuarial gain of ₹ 6 lakhs over the next 2 years by reducing the annual contributions to ₹ 2 lakhs instead of ₹ 5 lakhs. It has to contribute ₹ 5 lakhs annually for its pension schemes.

Accounting Standard 16

Question 63

In May, 2016, Speed Ltd. took a bank loan to be used specifically for the construction of a new factory building. The construction was completed in January, 2017 and the building was put to its use immediately thereafter. Interest on the actual amount used for construction of the building till its completion was 18 lakhs, whereas the total interest payable to the bank on the loan for the period till 31st March, 2017 amounted to ₹ 25 lakhs. Can ₹ 25 lakhs be treated as part of the cost of factory building and thus be capitalized on the plea that the loan was specifically taken for the construction of factory building?

Answer

AS 16 clearly states that capitalization of borrowing costs should cease when substantially all the activities necessary to prepare the qualifying asset for its intended use are completed. Therefore, interest on the amount that has been used for the construction of the building upto the date of completion (January, 2017) i.e. ₹ 18 lakhs alone can be capitalized. It cannot be extended to ₹ 25 lakhs.

Question 64

X Ltd. began construction of a new building on 1st January, 2017. It obtained ₹ 1 lakh special loan to finance the construction of the building on 1st January, 2017 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	*2017*	*2,00,000*
April	*2017*	*2,50,000*
July	*2017*	*4,50,000*
December	*2017*	*1,20,000*

Building was completed by 31st December, 2017. 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. (₹)*
31.12.2017	Building account	Dr.	10,94,189	
	To Bank account			10,94,189
	(Being amount of cost of building and borrowing cost thereon capitalized)			

* (₹ 6,22,500 – ₹ 1,00,000)

Question 65

The borrowings profile of Santra Pharmaceuticals Ltd. set up for the manufacture of antibiotics at Navi Mumbai is as under:

Date	*Nature of borrowings*	*Amount borrowed (₹)*	*Purpose of borrowings*	*Incidental expenses*
1st January, 2016	*15% demand loan*	*60 lakhs*	*Acquisition of fixed assets*	*8.33%*
1st July, 2016	*14.5% Term loan*	*40 lakhs*	*Acquisition of plant and machinery*	*5%*
1st October, 2016	*14% bonds*	*50 lakhs*	*Acquisition of fixed assets*	*8%*

The incidental expenses consist of commission and service charges for arranging the loans and are paid after rounding off to the nearest lakh.

Fixed assets considered as qualifying assets are as under:

	(₹)
Sterile Manufacturing shed	*10,00,000*
Plant and machinery (total)	*90,00,000*
Other fixed assets	*10,00,000*

The Project is completed on 1st January, 2017 and is ready for commercial production. Show the capitalization of the borrowing costs.

Answer

Specific Borrowings

	₹
14.5% Term Loan for acquisition of Plant & Machinery	
Interest from 1st July, 2016 to 31st December, 2016	
$= ₹\ 40,00,000 \times 14.5\% \times \frac{6}{12}$	2,90,000
Incidental Expenses	2,00,000
Total	4,90,000
General Borrowings	
15% Demand Loan	
Interest from 1st January, 2016 to 31st December, 2016 = ₹ 60,00,000 × 15%	9,00,000
Incidental Expenses	5,00,000
Sub Total (A)	14,00,000

14% Bonds	
Interest from 1st October, 2016 to 31st December, 2016	
$= ₹\ 50,00,000 \times 14\% \times \frac{3}{12}$	1,75,000
Incidental Expenses	4,00,000
Sub Total (B)	5,75,000
Total General Borrowing Cost (A+B)	19,75,000
Total Average Outstanding Borrowings will be as under:	
$\frac{(60,00,000 \times 12 + 50,00,000 \times 3)}{12}$	72,50,000
Weighted Average Borrowing Cost (WABC)= $\frac{\text{Total Borrowing Cost} \times 100}{\text{Total Average Outstanding}}$	
$\frac{19,75,000 \times 100}{72,50,000}$	= 27.24%

Allocation of General Borrowing Fund

Item	*Cost (₹)*	*Specific Borrowing (₹)*	*Net of specific borrowing (₹)*
Sterile Manufacturing Shed	10,00,000	Nil	10,00,000
Plant & Machinery	90,00,000	40,00,000	50,00,000
Other Fixed Assets	10,00,000	Nil	10,00,000

Item	*Expenditure on qualifying asset out of general borrowing (₹)*	*Capitalization Rate*	*Cost eligible for capitalization (₹)*
Sterile Manufacturing Shed	10,00,000	27.24	2,72,400
Plant & Machinery	50,00,000	27.24	13,62,000
Other Fixed Assets	10,00,000	27.24	2,72,400

Borrowing Costs to be Capitalized

Assets	*Specific Borrowing Cost (₹)*	*General Borrowing Cost (₹)*	*Total (₹)*
Sterile Manufacturing shed	Nil	2,72,400	2,72,400
Plant & Machinery	4,90,000	13,62,000	18,52,000
Other Fixed Assets	Nil	2,72,400	2,72,400
Total	4,90,000	19,06,800•	23,96,800

• Borrowing cost capitalized on general borrowings is ₹ 19,06,800 which is less than the actual borrowing cost.

Question 66

Rainbow Limited borrowed an amount of ₹ 150 crores on 1.4.2016 for construction of boiler plant @ 11% p.a. The plant is expected to be completed in 4 years. Since the weighted average cost of capital is 13% p.a., the accountant of Rainbow Ltd. capitalized ₹ 19.50 crores for the accounting period ending on 31.3.2017. Due to surplus fund out of ₹ 150 crores, income of ₹ 3.50 crores was earned and credited to profit and loss account. Comment on the above treatment of accountant with reference to relevant accounting standard.

Answer

Para 10 of AS 16 'Borrowing Costs' states "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." 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. Hence, in the above case, treatment of accountant of Rainbow Ltd. is incorrect. The amount of borrowing costs capitalized for the financial year 2016-2017 should be calculated as follows:

	₹ in crores
Actual interest for 2016-2017 (11% of ₹ 150 crores)	16.50
Less: Income on temporary investment from specific borrowings	(3.50)
Borrowing costs to be capitalized during year 2016-2017	13.00

Question 67

Fee Ltd. borrows a sum of ₹ 20 crore from Coffee Ltd., repayable as a single bullet payment at the end of 5 years. The interest thereon @ 5% p.a. is payable at yearly rests. Since the market is 8%, Fee Ltd. paid an origination fee of ₹ 2.40 crores to Coffee Ltd. to compensate Coffee Ltd. for the lower rate of interest. Apart from the above, there are no other transactions between the two parties. You are required to show the value at which Coffee Ltd., would recognize the loan and the annual interest thereon.

Answer

The fair value of the Loan to Coffee Ltd. is the present value of the interest it will receive over the next 5 years and the present value of repayment at the end of 5th year.

P.V. of interest discounted @ 8% = [(20,00,00,000 × 5%) × 3.9926] = ₹ 3,99,26,000 (A)

P.V. of principal amount = ₹ 20,00,00,000 discounted @ 8%

= ₹ 20,00,00,000 × 0.6806 =13,61,20,000 (B)

Fair Value of Loan (A + B) i.e. ₹ 17,60,46,000 (i.e. approximately ₹ 17,60,00,000 which is loan amount net of origination fee)

Therefore, Coffee Ltd will recognize the loan at ₹ 17.60 crores only.

Coffee Ltd will recognize the interest using the effective interest rate method as worked out below:

Year	*Amortised Cost (Opening Balance)*	*Interest income @ 8% to be recognised*	*Total*	*Payment received*	*Amortised Cost (Closing Balance)*
	(1)	*(2)*	*(3)*	*(4)*	*(5) = (3) – (4)*
1	17,60,00,000	1,40,80,000	19,00,80,000	1,00,00,000	18,00,80,000
2	18,00,80,000	1,44,06,400	19,44,86,400	1,00,00,000	18,44,86,400
3	18,44,86,400	1,47,58,912	19,92,45,312	1,00,00,000	18,92,45,312
4	18,92,45,312	1,51,39,625	20,43,84,937	1,00,00,000	19,43,84,937
5	19,43,84,937	1,56,15,063*	21,00,00,000	21,00,00,000	Nil

*Note: The interest in the 5th year, has been adjusted in accordance to the value received on closure.

Question 68

Sun Co-operative Society Ltd. has borrowed a sum of US$12.50 million at the commencement of the financial year 2016-2017 for its solar energy project at LIBOR (London Interbank Offered Rate) of 1% + 4%. The interest is payable at the end of the respective financial year. The loan was availed at the then rate of ₹ 45 to the US dollar while the rate as on 31st March, 2017 is ₹ 48 to the US dollar. Had Sun Co-operative Society Ltd. borrowed the Rupee equivalent in India, the interest would have been 11%. You are required to compute 'Borrowing Cost'. Also show the amount of exchange difference as per prevailing Accounting Standards.

Answer

Computation of Borrowing Cost as per para 4(e) of AS 16" Borrowing Costs" and Amount of Exchange Difference as per AS 11 "The Effects of Changes in Foreign Exchange Rates":

(a) Interest for the period 2016-2017

= US$ 12.5 million x 5% × ₹ 48 per US$ = ₹ 30 million

(b) Increase in the liability towards the principal amount

= US $ 12.5 million × ₹ (48 - 45) = ₹ 37.5 million

(c) Interest that would have resulted if the loan was taken in Indian currency

= US$ 12.5 million × ₹ 45 x 11% = ₹ 61.875 million

(d) Difference between interest on local currency borrowing and foreign currency borrowing = ₹ 61.875 million - ₹ 30 million = ₹ 31.875 million.

Therefore, out of ₹ 37.5 million increase in the liability towards principal amount, only ₹ 31.875 million will be considered as the borrowing cost. Thus, total borrowing cost would be ₹ 61.875 million being the aggregate of interest of ₹ 30 million on foreign currency borrowings plus the exchange difference to the extent of difference between interest on local currency borrowing and interest on foreign currency borrowing of ₹ 31.875 million.

Hence, ₹ 61.875 million would be considered as the borrowing cost to be accounted for as per AS 16 and the remaining ₹ 5.625 million (37.5 - 31.875) would be considered as the exchange difference to be accounted for as per AS 11.

Question 69

X Limited began construction of a new plant on 1st April 2016 and obtained a special loan of ₹ 8 lakhs to finance the construction of the plant. The rate of interest on loan was 10 per cent per annum.

The expenditure that was made on the project of plant construction was as follows:

	₹
1-4-2016	*10,00,000*
1-8-2016	*24,00,000*
1-1-2017	*4,00,000*

The Company's other outstanding non-specific loan was ₹ 46,00,000 at an interest of 12 percent per annum.

The construction of the plant was completed on 31-3-2017. You are required to calculate the amount of interest to be capitalized as per the provision of AS 16 of the borrowing cost (including cost).

Answer

(i) Computation of average accumulated expenses

		₹
₹ 10,00,000 x 12 / 12	=	10,00,000
₹ 24,00,000 x 8 / 12	=	16,00,000
₹ 4,00,000 x 3 / 12	=	1,00,000
		27,00,000

(ii) Non-specific Borrowings

Non-specific Borrowings= Average accumulated capital expenses – Specific borrowings

= ₹ 27,00,000 – ₹ 8,00,000 = ₹ 19,00,000

(ii) Interest on average accumulated expenses

		₹
Specific borrowings (₹ 8,00,000 x 10%)	=	80,000
Non-specific borrowings (₹ 19,00,000 × 12%)	=	2,28,000
Amount of interest to be capitalized	=	3,08,000

(iii) Total expenses to be capitalized for Plant

	₹
Cost of plant ₹ (10,00,000 + 24,00,000 + 4,00,000)	38,00,000
Add: Amount of interest to be capitalised	3,08,000
Total cost of plant	41,08,000

Question 70

Growth Ltd. has undertaken a project for expansion of capacity as per the following details:

	Plan (₹)	*Actual (₹)*
October, 2015	*5,00,000*	*4,00,000*
November, 2015	*6,50,000*	*7,95,000*
December, 2015	*20,00,000*	*-*
January, 2016	*2,00,000*	*50,000*
February, 2016	*9,00,000*	*2,00,000*
March, 2016	*10,00,000*	*12,00,000*

The company pays to its bank interest at a rate of 15% p.a., which is debited on a monthly basis. During the half year, company had ₹ 20 lakhs overdraft up to 31st December, surplus cash in January and again overdraft of ₹ 14 lakhs from 1.2.2016 and ₹ 30 lakhs from 1.3.2016. The company had a strike during December and hence could not continue the work during said period. However, the substantial administrative work related to the project was continued. Onsite work was again commenced on 1st January and all the work were completed on 31st March. Assume that expenditure was incurred on 1st day of each month.

Calculate interest to be capitalized giving reason wherever necessary. Assume overdraft will be less, if there is no capital expenditure.

Answer

Growth Ltd.

Month	*Actual Expenditure (₹)*	*Interest capitalized (₹)*	*Cumulative amount (₹)*
October, 2015	4,00,000	5,000	4,05,000
Nov., 2015	7,95,000	15,000	12,15,000
Dec., 2015	-	15,188	12,30,188
January, 2016	50,000	-	12,80,188
February,2016	2,00,000	17,500	14,97,688
March, 2016	12,00,000	33,721	27,31,409
	26,45,000	86,409	

Note:

1. As per para 18 of AS 16, 'Borrowing Cost', capitalisation of borrowing costs is not normally suspended during a period when substantial technical and administrative work is being carried out. Therefore, the interest for that period i.e. for the month of December has also been capitalized.
2. During January, the company did not incur any interest as there was surplus cash in January. Therefore, no amount should be capitalized during January as per para 14(b) of AS 16.
3. During February, actual overdraft (borrowings) was ₹ 14 lakhs only. Hence, interest of ₹ 17,500 on ₹ 14,00,000 has been calculated even though actual expenditure on project exceed ₹ 14 lakhs.

Question 71

Harish Construction Company is constructing a huge building project consisting of four phases. It is expected that the full building will be constructed over several years but Phase I and Phase II of the b uilding will be started as soon as they are completed.

Following is the detail of the work done on different phases of the building during the current year:

(₹ in lakhs)

	Phase I	*Phase II*	*Phase III*	*Phase IV*
	₹	₹	₹	₹
Cash expenditure	*10*	*30*	*25*	*30*
Building purchased	*24*	*34*	*30*	*38*
Total expenditure	*34*	*64*	*55*	*68*

Total expenditure of all phases				*221*
Loan taken @ 15% at the beginning of the year				*200*

During the current year, Phase I and Phase II have become operational. Find out the total amount to be capitalized and to be expensed during the year.

Answer

	Particulars	₹
1.	Interest expense on loan ₹ 2,00,00,000 at 15%	30,00,000
2	Total cost of Phases I and II (₹ 34,00,000 +64,00,000)	98,00,000
3.	Total cost of Phases III and IV (₹ 55,00,000 + ₹ 68,00,000)	1,23,00,000
4.	Total cost of all 4 phases	2,21,00,000
5.	Total loan	2,00,00,000
6.	Interest on loan used for Phases I & II, based on proportionate Loan amount = $\frac{30,00,000}{2,21,00,000} \times 98,00,000$	13,30,317 (approx.)
7.	Interest on loan used for Phases III & IV, based on proportionate Loan amount= $\frac{30,00,000}{2,21,00,000} \times 1,23,00,000$	16,69,683 (approx.)

Accounting treatment:

1. For Phase I and Phase II

Since Phase I and Phase II have become operational during the year (assumed as mid of the year), half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be capitalized (in the ratio of asset costs 34:64) and added to respective assets in Phase I and Phase II and remaining half of the interest amount of ₹ 6,65,158.50 (i.e. ₹ 13,30,317/2) relating to Phase I and Phase II should be expensed off during the year.

2. For Phase III and Phase IV

Interest of ₹ 16,69,683 relating to Phase III and Phase IV should be held in Capital Work-in-Progress till assets construction work is completed, and thereafter capitalized in the ratio of cost of assets. No part of this interest amount should be charged/expensed off during the year since the work on these phases has not been completed yet.

Accounting Standard 17

Question 72

The Chief Accountant of Sports Ltd. gives the following data regarding its six segments:

₹ in lakhs

Particulars	*M*	*N*	*O*	*P*	*Q*	*R*	*Total*
Segment Assets	*40*	*80*	*30*	*20*	*20*	*10*	*200*
Segment Results	*50*	*(190)*	*10*	*10*	*(10)*	*30*	*(100)*
Segment Revenue	*300*	*620*	*80*	*60*	*80*	*60*	*1,200*

The Chief accountant is of the opinion that segments "M" and "N" alone should be reported. Is he justified in his view? Discuss.

Answer

As per para 27 of AS 17 'Segment Reporting', a business segment or geographical segment should be identified as a reportable segment if:

(i) Its revenue from sales to external customers and from other transactions with other segments is 10% or more of the total revenue- external and internal of all segments; or

(ii) Its segment result whether profit or loss is 10% or more of:

(1) The combined result of all segments in profit; or

(2) The combined result of all segments in loss,

whichever is greater in absolute amount; or

(iii) Its segment assets are 10% or more of the total assets of all segments.

If the total external revenue attributable to reportable segments constitutes less than 75% of total enterprise revenue, additional segments should be identified as reportable segments even if they do not meet the 10% thresholds until atleast 75% of total enterprise revenue is included in reportable segments.

(a) On the basis of turnover criteria segments M and N are reportable segments.

(b) On the basis of the result criteria, segments M, N and R are reportable segments (since their results in absolute amount is 10% or more of ₹ 200 lakhs).

(c) On the basis of asset criteria, all segments except R are reportable segments.

Since all the segments are covered in atleast one of the above criteria all segments have to be reported upon in accordance with Accounting Standard (AS) 17. Hence, the opinion of chief accountant is wrong.

Question 73

A Company has an inter-segment transfer pricing policy of charging at cost less 10%. The market prices are generally 25% above cost. Is the policy adopted by the company correct?

Answer

AS 17 'Segment Reporting' requires that inter-segment transfers should be measured on the basis that the enterprise actually used to price these transfers. The basis of pricing inter-segment transfers and any change therein should be disclosed in the financial statements. Hence, the enterprise can have its own policy for pricing inter-segment transfers and hence, inter-segment transfers may be based on cost, below cost or market price. However, whichever policy is followed, the same should be disclosed and applied consistently. Therefore, in the given case inter-segment transfer pricing policy adopted by the company is correct if, followed consistently.

Question 74

M/s XYZ Ltd. has three segments namely X, Y, Z. The total Assets of the Company are ₹ 10.00 crores. Segment X has ₹ 2.00 crores, segment Y has ₹ 3.00 crores and segment Z has ₹ 5.00 crores. Deferred tax assets included in the assets of each segments are X- ₹ 0.50 crores, Y— ₹ 0.40 crores and Z— ₹ 0.30 crores. The accountant contends that all the three segments are reportable segments. Comment.

Answer

According to AS 17 "Segment Reporting", segment assets do not include income tax assets. Therefore, the revised total assets are ₹ 8.8 crores [₹ 10 crores – (₹ 0.5 + ₹ 0.4 + ₹ 0.3)]. Segment X holds total assets of ₹ 1.5 crores (₹ 2 crores – ₹ 0.5 crores); Segment Y holds ₹ 2.6 crores (₹ 3 crores – ₹ 0.4 crores); and Segment Z holds ₹ 4.7 crores (₹ 5 crores – ₹ 0.3 crores). Thus all the three segments hold more than 10% of the total assets, all segments are reportable segments.

Accounting Standard 18

Question 75

Who are related parties under AS 18? What are the related party disclosure requirements?

Answer

Parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

If there have been transactions between related parties, during the existence of a related party relationship, the reporting enterprise should disclose the following:

(i) the name of the transacting related party;

(ii) a description of the relationship between the parties;

(iii) a description of the nature of transactions;

(iv) volume of the transactions either as an amount or as an appropriate proportion;

(v) any other elements of the related party transactions necessary for an understanding of the financial statements;

(vi) the amounts or appropriate proportions of outstanding items pertaining to related parties at the balance sheet date and provisions for doubtful debts due from such parties at that date; and

(vii) amounts written off or written back in the period in respect of debts due from or to related parties.

Question 76

P Ltd. has 60% voting right in Q Ltd. Q Ltd. has 20% voting right in R Ltd. Also, P Ltd. directly enjoys voting right of 14% in R Ltd. R Ltd. is a listed company and regularly supplies goods to P Ltd. The management of R Ltd. has not disclosed its relationship with P Ltd.

How would you assess the situation from the viewpoint of AS 18 on Related Party Disclosures?

Answer

P Ltd. has direct economic interest in R Ltd to the extent of 14%, and through Q Ltd. in which it is the majority shareholders, it has further control of 12% in R Ltd. (60% of Q Ltd.'s 20%). These two taken together (14% + 12%) make the total control of 26%.

Para 10 of AS 18 'Related Party Disclosures', defines *related party* as one that has at any time during the reporting period, the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.

Here, Control is defined as ownership directly or indirectly of more than one-half of the voting power of an enterprise; and *Significant Influence* is defined as participation in the financial and/or operating policy decisions of an enterprise but not control of those policies.

In the present case, control of P Ltd. in R Ltd. directly and through Q Ltd., does not go beyond 26%. However, as per para 12 of AS 18, significant influence may be exercised as an investing party (P Ltd.) holds, directly or indirectly through intermediaries 20% or more of the voting power of the R Ltd. As R Ltd. is a listed company and regularly supplies goods to P Ltd. therefore, related party disclosure, as per AS 18, is required.

Accounting Standard 19

Question 77

Distinguish between operating lease and finance lease.

Answer

Basis of Classification: Leases are classified 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.

As per AS 19 "Accounting for Lease", Lease may be of two types: a) Finance Lease b) Operating Lease.

Finance Lease is a lease which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership.

Operating lease is a lease which does not transfers substantially all the risks and rewards incidental to ownership. To be precise, it is a lease other than "Financial Lease".

Question 78

AS Ltd. leased a machine to SB Ltd. on the following terms:

	(₹ in lakhs)
Fair value of the machine	*4.00*
Lease term	*5 years*
Lease Rental Per annum	*1.00*
Guaranteed Residual value	*0.20*
Expected Residual value	*0.40*
Internal Rate of Return	*15%*

Depreciation is provided on straight line method at 10 per cent per annum. Ascertain Unearned Financial Income. Necessary Journal entries in the books of the Lessee in first year may be shown.

Answer

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)

= [(₹ 1,00,000 × 5 years) + ₹ 20,000] + ₹ 20,000 = ₹ 5,40,000 (a)

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

Year	*M.L.P. inclusive of URV* ₹	*Internal rate of return (Discount factor @ 15%)*	*Present Value* ₹
1	1,00,000	0.8696	86,960
2	1,00,000	0.7561	75,610
3	1,00,000	0.6575	65,750
4	1,00,000	0.5718	57,180
5	1,00,000	0.4972	49,720
	20,000(GRV)	0.4972	9,944
	5,20,000		3,45,164 (i)
	20,000 (URV)	0.4972	9,944 (ii)
	5,40,000	(i) + (ii)	3,55,108 *(b)*

Unearned Finance Income = (a) – (b) = ₹ 5,40,000 – ₹ 3,55,108 = ₹ 1,84,892

Journal Entries in the books of SB Ltd.

		₹	₹
At the inception of lease			
	Machinery account	Dr. 3,45,164*	
	To AS Ltd.'s account		3,45,164*
	(Being lease of machinery recorded at present value of minimum lease payments)		
At the end of the first year of lease			
	Finance charges account (Refer Working Note)	Dr. 51,775	
	To AS Ltd.'s account		51,775
	(Being the finance charges for first year due)		

* As per para 11 of AS 19, the lessee should recognize the lease as an asset and a liability at an amount equal to the fair value of the leased asset at the inception of lease. However, if the fair value of the leased asset exceeds the present value of minimum lease payments from the standpoint of lessee, the amount recorded should be the present value of these minimum lease payments. Therefore, in this case, as the fair value of ₹ 4,00,000 is more than the present value amounting ₹ 3,45,164, the machinery has been recorded at ₹ 3,45,164 in the books of SB Ltd. (the lessee) at the inception of the lease. According to para 13 of the standard, at the inception of the lease, the asset and liability for the future lease payments are recognised in the balance sheet at the same amounts.

	AS Ltd.'s account	Dr. 1,00,000	
	To Bank account		1,00,000
	(Being the lease rent paid to the lessor which includes outstanding liability of ₹ 48,225 and finance charge of ₹ 51,775)		
	Depreciation account[£]	Dr. 34,516	
	To Machinery account		34,516
	(Being the depreciation provided @ 10% p.a. on straight line method)		
	Profit and loss account	Dr. 86,291	
	To Depreciation account		34,516
	To Finance charges account		51,775
	(Being the depreciation and finance charges transferred to profit and loss account)		

Working Note:

Table showing apportionment of lease payments by SB Ltd. between the finance charges and the reduction of outstanding liability

Year	*Outstanding liability (opening balance) (a)* ₹	*Minimum lease payments (b)* ₹	*Finance charges (c = a x 15%)* ₹	*Reduction in principal amount (d= b-c)* ₹	*Outstanding liability (closing balance (e = a-d)* ₹
1	3,45,164	1,00,000	51,775	48,225	2,96,939
2	2,96,939	1,00,000	44,541	55,459	2,41,480
3	2,41,480	1,00,000	36,222	63,778	1,77,702
4	1,77,702	1,00,000	26,655	73,345	1,04,357
5	1,04,357	1,00,000	15,654	84,346	20,011[•]

[£] Depreciation has been provided on the basis that the machine has been leased at the beginning of the year.

[•] The difference between this figure and guaranteed residual value (₹ 20,000) is due to approximation in computing the interest rate implicit in the lease.

Question 79

Suraj Limited wishes to obtain a machine costing ₹ 30 lakhs by way of lease. The effective life of the machine is 14 years, but the company requires it only for the first 5 years. It enters into an agreement with Ashok Ltd., for a lease rental for ₹ 3 lakhs p.a. payable in arrears and the implicit rate of interest is 15%. The chief accountant of Suraj Limited is not sure about the treatment of these lease rentals and seeks your advise.

Answer

As per AS 19 'leases', a lease will be classified as finance lease if at the inception of the lease, the present value of minimum lease payment• amounts to at least substantially all of the fair value of leased asset. In the given case, the implicit rate of interest is given at 15%. The present value of minimum lease payments at 15% using PV- Annuity Factor can be computed as:

Annuity Factor (Year 1 to Year 5)	3.36 (approx.)
Present Value of minimum lease payments (₹ 3 lakhs each year)	₹ 10.08 lakhs (approx.)

Thus present value of minimum lease payments is ₹ 10.08 lakhs and the fair value of the machine is ₹ 30 lakhs. In a finance lease, lease term should be for the major part of the economic life of the asset even if title is not transferred. However, in the given case, the effective useful life of the machine is 14 years while the lease is only for five years. Therefore, lease agreement is an operating lease. Lease payments under an operating lease should be recognized 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.

Question 80

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.

• In calculating the present value of the of minimum lease payments, the discount rate is the interest rate implicit in the lease.

Answer

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.

Question 81

On 1st January, 2016, Santa Ltd. sold equipment for ₹ 6,14,460. The carrying amount of the equipment on that date was ₹ 1,00,000. The sale was a part of the package under which Banta Ltd. leased the asset to Santa Ltd. for ten years term. The economic life of the asset is estimated as 10 years. The minimum lease rents payable by the lessee has been fixed at ₹ 1,00,000 payable annually beginning from 31st December, 2016. The incremental borrowing interest rate of Santa Ltd. is estimated at 10% p.a. Calculate the net effect on the Statement of profit and loss in the books of Santa Ltd.

Answer

Net effect on the Statement of Profit and Loss in the year of sale in the books of Lessee (Santa Ltd.)

For calculation of net effect on the statement of profit and loss on sale of equipment, it has to be judged whether lease is an operating lease or finance lease.

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

The lease term is for 10 years which covers the entire economic life of the equipment. At the inception of the lease, the present value of the minimum lease payments (MLP) is ₹ 6,14,400 [₹ 1,00,000 x 6.144 (Annuity factor of ₹ 1 @10% for 10 years)] and amounts to at least substantially all of the fair value (sale price i.e. ₹ 6,14,460) of the leased equipment. Thus lease is a finance lease.

As per para 48 of AS 19 "Leases", if a sale and leaseback transaction results in a finance lease, profit of ₹ 5,14,460 (Sale value ₹ 6,14,460 less carrying amount ₹ 1,00,000) will not be recognized as income in the year of sale in the books of lessee i.e. Santa Ltd. It should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.

Therefore, assuming that depreciation is charged on straight line basis, Santa Ltd. will recognize depreciation of ₹ 61,446 per annum for 10 years (₹ 6,14,460/ 10) and amortise profit of ₹ 5,14,460 over the lease term of 10 years, i.e. ₹ 51,446 p.a. The net effect is a debit of (₹ 61,446 - ₹ 51,446) ₹ 10,000 p.a. to the Statement of profit and loss, for 10 years as covered under the lease term.

Note: Had there been no sale and lease back transaction, the Statement of profit and loss for each year (covered in the lease term) would have been charged by (₹ 1,00,000/10) ₹ 10,000, towards depreciation. Thus, the sale and lease back transaction will have no impact on profit or loss account to be reported by the lessee (vendor in the sales transaction) over the lease period.

Accounting Standard 20

Question 82

Mohur Ltd. has equity capital of ₹ 40,00,000 consisting of fully paid equity shares of ₹ 10 each. The net profit for the year 2016-2017 was ₹ 60,00,000. It has also issued 36,000, 10% convertible debentures of ₹ 50 each. Each debenture is convertible into five equity shares. The tax rate applicable is 30%. Compute the diluted earnings.

Answer

Interest on Debentures @ 10% for the year		$36{,}000 \times ₹\ 50 \times \frac{10}{100}$
	=	₹ 1,80,000
Tax on interest @ 30%	=	₹ 54,000
Diluted Earnings (Adjusted net profit)	=	(₹ 60,00,000 + ₹ 1,80,000 - ₹ 54,000)
	=	₹ 61,26,000

Question 83

From the following information of Beta Ltd. calculate Earnings Per Share (EPS) in accordance with AS 20:

		(₹) Year 31.3.15	(₹) Year 31.3.14
1.	*Net profit before tax*	*3,00,000*	*1,00,000*
2.	*Less: Current tax*	*(40,000)*	*(30,000)*
	Tax relating to earlier years	*(24,000)*	*13,000*
	Deferred tax	*(30,000)*	*(10,000)*
3.	*Profit after tax*	*2,06,000*	*73,000*
4.	*Other information:*		
	(a) Profit includes compensation from Central Government towards loss on account of earthquake in 2014 (non-taxable)	*1,00,000*	*NIL*
	(b) Outstanding convertible 6% Preference shares 1,000 issued and paid on 30.9.2015. Face value ₹ 100, conversion ratio 15 equity shares for every preference share.		
	(c) 15% convertible debentures of ₹ 1,000 each total face value ₹ 1,00,000 to be converted into 10 Equity shares per debenture issued and paid on 30.6.2015.		
	(d) Total number of equity shares outstanding as on 31.3.2017, 20,000 including 10,000 bonus shares issued on 1.1.2017, face value ₹ 100.		

Answer

Calculation of Earnings Per Share (EPS) of Beta Ltd.

			₹ Year ended 31.3.15	₹ Year ended 31.3.14
1.	A	Earning after extra ordinary items for equity shareholders (₹ 2,06,000 – ₹ 6,000) (₹ 73,000 – ₹ 3,000)	2,00,000	70,000
	B.	No. of Equity Shares	20,000	20,000
	C.	Basic Earnings Per share [A/B]	10.00	3.50
	A.	Earnings before extraordinary items	1,00,000	70,000
	B.	No. of Equity Shares	20,000	20,000*
	C.	Basic Earnings Per share [A/B]	5.00	3.50

* Since the bonus issue is without consideration, the issue is treated as if it had occurred prior to the beginning of the year 2016.

2.	Tax rate applicable		
	₹ 40,000 + ₹ 30,000 / ₹ 2,00,000×100	35%	
	₹ 30,000 + ₹ 10,000 / ₹ 1,00,000×100		40%
3.	A. Dividend on Weighted Average Preference Shares	6,000	3,000
	B. Incremental shares	15,000	7,500
	C. EPS on Incremental Shares [A/B]	0.40	0.40
		(dilutive)	(dilutive)
4.	Convertible Debentures		
	A. Increase in earnings		
	$(1,00,000 \times \frac{15}{100} \times .65)$	9,750	
	$1,00,000 \times \frac{15}{100} \times .60 \times \frac{9}{12}$		6,750
	B. Increase in shares	1,000	750
	C. Increase in EPS [A/B]	9.75	9.00
		(Anti dilutive)	(Anti dilutive)

It is anti-dilutive as it increases the EPS from continuing ordinary operations (Para 39, AS 20)

	Calculation of Diluted EPS	*Year ended 31.3.15 (₹)*	*Year ended 31.3.14 (₹)*
A.	Profit from continuing ordinary activities before Preference Dividend	1,06,000	73,000
	No. of ordinary equity shares	20,000	20,000
	Adjustment for dilutive potential of 6% convertible pref. shares	15,000	7,500
B.	Total no. of shares	35,000	27,500
C.	Diluted EPS from continuing ordinary operations [A/B]	3.02	2.65
D.	Profit including extra ordinary items	2,06,000	73,000
E.	Adjusted No. of shares	35,000	27,500
F.	Diluted EPS including extra ordinary items [D/E]	5.88	2.65

Disclosure of EPS in accordance with AS 20 in the Profit and Loss Account

Earnings per share (Face value ₹ 100)	*31.3.15 (₹)*	*31.3.14 (₹)*
Basic EPS from continuing ordinary operations	5.00	3.50
Diluted EPS from continuing ordinary operations	3.02	2.65

Question 84

From the information furnished you are required to compute the Basic and Diluted EPS (earnings per share) for accounting year 01-04-2016 to 31-03-2017 and adjusted EPS for the year 01-04-2015 to 31-03-2016.

Net profit for the year ended 31-03-2016	*₹ 75,50,000*
Net profit for the year ended 31-03-2017	*₹ 1,00,25,000*
No. of equity shares as on 01-04-2016	*50,00,250*
Bonus issue on 01-01-2017	*1 share for every 2 held*
No. of 12% Convertible Debentures of ₹ 100 each issued on 01-01-2017	*1,00,000*
Conversion ratio of Debentures	*10 shares per debenture*
Tax rate	*30 percent*

Answer

No. of bonus shares issued as on 1.1.2017

On existing shares (50,00,250 x ½) 25,00,125 shares

On convertible debentures as per SEBI Guidelines on Bonus Issue

(1,00,000 debentures x 10 shares x ½) 5,00,000 shares

Basic Earnings per share for the year 2016-2017 =

$$\frac{\text{Net profit for the year ended 31.3.2017}}{\text{Weighted average number of equity share as on 31.3.2017}}$$

$$\frac{₹\ 1,00,25,000}{(50,00,250+25,00,125+5,00,000)} = ₹\ 1.25$$

Adjusted earnings per share for the year 2015-2016 = $\frac{₹\ 75,50,000}{(50,00,250+25,00,125+5,00,000)}$

= ₹ 0.94

For Diluted EPS

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 = ₹ 1,00,25,000 + (12,00,000 -3,60,000) x3/12

= ₹ 1,02,35,000

No. of equity shares resulting from conversion of debentures

= 1,00,000 x 10 shares = 10,00,000

No. of equity shares used to compute diluted earnings per share

= 50,00,250 + 25,00,125 + 5,00,000 + (10,00,000 x 3/12)

= 50,00,250 + 25,00,125 + 5,00,000 + 2,50,000

= 82,50,375 shares

Diluted earnings per share = 1,02,35,000/82,50,375 = ₹ 1.24

Note: As per AS 20, bonus shares issued to existing shareholders and to convertible debenture holders (on conversion of debentures into shares) are an issue without consideration. Therefore, it is treated as if it had occurred prior to the beginning of the year 2015-2016, the earliest period reported.

Question 85

The directors of Aqua Limited are considering the acquisition of an existing company Bose Limited engaged in a line of business suited to them. The financial data at the time of acquisition being:

	Aqua Ltd.	*Bose Ltd.*
Net profit after tax	*₹ 36,00,000*	*₹ 7,20,000*
Number of shares	*7,20,000*	*3,00,000*
Market price per share	*₹ 150*	*₹ 50*
Earnings per share	*₹ 5*	*₹ 2.50*
Price earnings ratio	*30*	*20*

It is expected that the net profit after tax of the two companies would continue to be ₹ 43,20,000. Aqua Limited would pay the amount in the form of shares of Aqua Limited.

Explain the effect on EPS of the merged company if Aqua Limited offers to pay ₹ 60 per share to the shareholders of Bose Limited.

Answer

In the given case, Aqua Ltd. offers to pay ₹ 60 per share to Bose Ltd.

The share exchange ratio would be $\frac{60}{150} = 0.4$

It means, Aqua Ltd. would give 0.4 share for every one share of Bose Ltd. In other words, Aqua Ltd. would give 2 shares for 5 shares of Bose Ltd.

The total number of shares to be issued by Aqua Ltd. to Bose Ltd.

= 3,00,000× 0.4 = 1,20,000 shares

Total number of shares of Aqua Ltd. after acquisition of Bose Ltd.

= 7,20,000 + 1,20,000 = 8,40,000 shares

Calculation of E.P.S. of the amalgamated company = $\frac{\text{Total Net Profit after Interest and Tax}}{\text{Total Number of shares}}$

= 43,20,000 / 8,40,000

= ₹ 5.14 per share

After amalgamation, the EPS of Aqua Ltd., will improve from ₹ 5 to ₹ 5.14.

Note: Earnings per share of Bose Ltd., i.e. ₹ 2.50 per share as given in the question, does not tally with the calculation i.e. 7,20,000 / 3,00,000 = ₹ 2.40 per share. However, the above solution has been given on the basis of EPS of Bose Ltd. as given in the question.

Accounting Standard 21

Question 86

A Ltd. had acquired 80% shares in the B Ltd. for ₹ 15 lakhs. The net assets of B Ltd. on that day are ₹ 22 lakhs. During the year, A Ltd. sold the investment for ₹ 30 lakhs and net assets of B Ltd. on the date of disposal was ₹ 35 lakhs. Calculate the profit or loss on disposal of this investment to be recognized in the Financial Statements of A Ltd.

Answer

Calculation of Profit/Loss on disposal of investment in subsidiary

Particulars	₹
Proceeds from the sale of Investment	30,00,000
Less: A Ltd.'s share in net assets of B Ltd. (W.N.1)	(28,00,000)
	2,00,000
Add: Capital Reserve at the time of acquisition of shares in B Ltd. (W.N.2)	2,60,000
Profit on sale of investment	4,60,000

Working Notes:

1. A Ltd.'s share in net assets of B Ltd.

	₹
Net Assets of B Ltd. on the date of disposal	35,00,000

Less: Minority Interest (20% of ₹ 35 lakhs)	(7,00,000)
A Ltd.'s share in the net assets of B Ltd.	28,00,000

2. Capital Reserve at time of acquisition of shares in B Ltd.

	₹
A Ltd.'s share in the net assets of B Ltd. on the date of acquisition (80% of ₹ 22 lakhs)	17,60,000
Less: Cost of investment	(15,00,000)
Capital Reserve at time of acquisition of shares in B Ltd.	2,60,000

Question 87

Ram Ltd. holds 80% share in Shyam Ltd., its subsidiary. Share capital of Shyam Ltd. is ₹ 25,00,000 and reserves being ₹ 5,00,000 on the date of acquisition 31.3.2012.

Following is the results of Shyam Ltd.:

Year ended	*Profit/(Loss)*	*Net worth (₹ in lakhs)*
31.3.2013	*(15,00,000)*	*+15.00*
31.3.2014	*(20,00,000)*	*(5.00)*
31.3.2015	*4,00,000*	*(1.00)*
31.3.2016	*5,00,000*	*+4.00*

Calculate minority interest for the period from 2011-2012 to 2015-2016 as per AS 21.

Answer

As per AS 21 "Consolidated Financial Statements", the losses applicable to the minority in a consolidated subsidiary may exceed the minority interest in the equity of the subsidiary. The excess, and any further losses applicable to the minority, are adjusted against the majority interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. If the subsidiary subsequently reports profits, all such profits are allocated to the majority interest until the minority's share of losses previously absorbed by the majority has been recovered. Accordingly,

Year	*Details*	*Minority Interest (MI) (20%)*	*Minority's Share of losses borne by Ram Ltd.*
			Balance
Minority Interest at the time of acquisition i.e. on 31.3.2012		6,00,000 (W.N.)	

2012-13	(15,00,000 x 20%)	(3,00,000)	
on 31.3.2013		3,00,000	
2013-14	(20,00,000 x 20%)	(4,00,000)	
		(1,00,000)	
	Loss amounting ₹ 1,00,000 of minority borne by majority shareholders on application of AS 21	1,00,000	1,00,000
on 31.3.2014		Nil	
2014-15	(4,00,000 x 20%)	80,000	
	On application of AS 21, profit transferred to majority shareholders	(80,000)	(80,000)
on 31.3.2015		Nil	20,000
2015-16	(5,00,000 x 20%)	1,00,000	
	On application of AS 21, profit transferred to majority shareholders to the extent earlier loss was borne by majority share holders	(20,000)	(20,000)
on 31.3.2016		80,000	Nil

Working Note:

Calculation of Minority Interest as on 31.3.2012

	Total Amount (100%) (₹)	*Minority Interest (20%) (₹)*
Share Capital (20%)	25,00,000	5,00,000
Add: Share in Reserves (20%)	5,00,000	1,00,000
		6,00,000

Accounting Standard 22

Question 88

Write short note on Timing differences and Permanent differences as per AS 22.

Answer

In current practices, companies, in general, prepare books of accounts as per Companies Act, generating Accounting Profit/Loss and Income Tax Act, generating Taxable Profit/Loss. Accounting income and taxable income for a period are seldom the same.

Permanent differences are those which arise in one period and do not reverse subsequently. For e.g., an income exempt from tax or an expense that is not allowable as a deduction for tax purposes.

Timing differences are those which arise in one period and are capable of reversal in one or more subsequent periods. For e.g., Depreciation, Sales Tax, Bonus etc., U/s 43B.

Question 89

Omega Limited is working on different projects which are likely to be completed within 3 years period. It recognizes revenue from these contracts on percentage of completion method for financial statements during 2014-2015, 2015-2016 and 2016-2017 for ₹ 11,00,000, ₹ 16,00,000 and ₹ 21,00,000 respectively. However, for Income-tax purpose, it has adopted the completed contract method under which it has recognized revenue of ₹ 7,00,000, ₹ 18,00,000 and ₹ 23,00,000 for the years 2014-2015, 2015-2016 and 2016-2017 respectively. Income-tax rate is 35%. Compute the amount of deferred tax asset/liability for the years 2014-2015, 2015-2016 and 2016-2017.

Answer

Omega Limited.

Calculation of Deferred Tax Asset/Liability

Year	*Accounting Income*	*Taxable Income*	*Timing Difference (balance)*	*Deferred Tax Liability (balance)*
2014-2015	11,00,000	7,00,000	4,00,000	1,40,000
2015-2016	16,00,000	18,00,000	2,00,000	70,000
2016-2017	21,00,000	23,00,000	NIL	NIL
	48,00,000	48,00,000		

Question 89

Y Ltd. is a full tax free enterprise for the first ten years of its existence and is in the second year of its operation. Depreciation timing difference resulting in a tax liability in year 1 and 2 is ₹ 200 lakhs and ₹ 400 lakhs respectively. From the third year it is expected that the timing difference would reverse each year by ₹ 10 lakhs. Assuming tax rate of 40%, find out the deferred tax liability at the end of the second year and any charge to the Profit and Loss account.

Answer

As per para 13 of Accounting Standard (AS) 22, Accounting for Taxes on Income", deferred tax in respect of timing differences which originate during the tax holiday period and reverse during the tax holiday period, should not be recognised to the extent deduction from the total income of an enterprise is allowed during the tax holiday period as per the provisions of sections 10A and 10B of the Income-tax Act. Deferred tax in respect of timing differences which originate during the tax holiday period but reverse after the tax holiday period should be recognised in the year in which the timing differences originate. However, recognition of deferred tax assets should be subject to the consideration of prudence. For this purpose, the timing differences which originate first should be considered to reverse first.

Out of ₹ 200 lakhs depreciation, timing difference amounting ₹ 80 lakhs (₹ 1 0 lakhs x 8 years) will reverse in the tax holiday period and therefore, should not be recognised. However, for ₹ 120 lakhs (₹ 200 lakhs – ₹ 80 lakhs), deferred tax liability will be recognised for ₹ 48 lakhs (40% of ₹ 120 lakhs) in first year. In the second year, the entire amount of timing difference of ₹ 400 lakhs will reverse only after tax holiday period and hence, will be recognised in full. Deferred tax liability amounting ₹ 160 lakhs (40% of ₹ 400 lakhs) will be created by charging it to profit and loss account and the total balance of deferred tax liability account at the end of second year will be ₹ 208 lakhs (48 lakhs + 160 lakhs).

Question 90

Rama Ltd., has provided the following information:

	₹
Depreciation as per accounting records	*= 2,00,000*
Depreciation as per income tax records	*= 5,00,000*
Unamortized preliminary expenses as per tax record	*= 30,000*

There is adequate evidence of future profit sufficiency. How much deferred tax asset/liability should be recognized as transition adjustment? Tax rate 50%.

Answer

Table showing calculation of deferred tax asset / liability

Particulars	*Amount*	*Timing differences*	*Deferred tax*	*Amount @ 50%*
	₹			₹
Excess depreciation as per tax records (₹ 5,00,000 – ₹ 2,00,000)	3,00,000	Timing	Deferred tax liability	1,50,000
Unamortised preliminary expenses as per tax records	30,000	Timing	Deferred tax asset	(15,000)
Net deferred tax liability				1,35,000

Question 91

Acute Ltd. is the owner of a CGU (Cash Generating Unit) block of assets whose current carrying cost is ₹ 999 lakhs. The company, after a detailed study by its technical team, has assessed the present recoverable amount of this CGU block of assets at ₹ 555 lakhs. The value of the block of assets as per the Income tax Records is ₹ 777 lakhs. The Approving Authority of the company have issued a signed statement confirming that the impairment in the value of the CGU is only a temporary phenomenon which is reversible in subsequent periods and also assuring virtual certainty of taxable incomes in the foreseeable future. You are required to show Deferred Tax workings as per Accounting Standards in force, given the tax rate of 30% plus 10% surcharge thereon. The depreciation rate for tax purposes is 15% and that per books is 13.91%.

Answer

Assumption: It is assumed that current carrying cost of the CGU block of asset as per Accounting and Tax Records are after charging depreciation of the current year. The assumption has been taken on the basis that impairment loss is calculated on carrying value after charging depreciation of the year.

In the absence of specific instructions, deferred tax workings of current year have been shown as below:

Statement showing Deferred Tax workings for the current year

		₹ *in lakhs*
Depreciation as per Accounting books for the current year $\frac{999}{(1-.1391)}\times.1391$		161.41
Depreciation as per Income Tax Records for the current year $\frac{777}{(1-.15)}\times.15$		137.12
Timing difference		24.29
Tax effect of the above timing difference at 33%* (deferred tax asset)	(A)	8.02
Impairment Loss recognised in the profit and loss account (999- 555)		444
Impairment Loss allowed for tax purposes		Nil
Timing difference		444
Tax effect of the above timing difference at 33% (deferred tax asset) (B)		146.52
Total deferred tax asset (A+B)		154.54

*Tax rate = 30%x 110%= 33%.

Note:

1. Deferred tax asset should be recognised and carried forward only to the extent that there is a reasonable certainty that sufficient future taxable income will be available against which such deferred tax asset can be realised. The Approving Authority of Acute Ltd. have issued signed statement confirming virtual certainty of taxable incomes in the foreseeable future. Therefore, the company can recognize deferred tax asset during the current year.

2. The deferred tax asset calculated on account of difference of depreciation as per accounting and tax records is actually a reversal of deferred tax liability created in the previous years.

Accounting Standard 23

Question 92

A Ltd. acquired 25% of shares in B Ltd. as on 31.3.2016 for ₹ 3 lakhs. The Balance Sheet of B Ltd. as on 31.3.2016 is given below:

	₹
Share Capital	*5,00,000*
Reserves and Surplus	*5,00,000*
	10,00,000
Fixed Assets	*5,00,000*
Investments	*2,00,000*
Current Assets	*3,00,000*
	10,00,000

During the year ended 31.3.2017 the following are the additional information available:

(i) A Ltd. received dividend from B Ltd., for the year ended 31.3.2016 at 40% from the Reserves.

(ii) B Ltd., made a profit after tax of ₹ 7 lakhs for the year ended 31.3.2017.

(iii) B Ltd., declared a dividend @ 50% for the year ended 31.3.2017 on 30.4.2017.

A Ltd. is preparing Consolidated Financial Statements in accordance with AS 21 for its various subsidiaries. Calculate:

(i) Goodwill if any on acquisition of B Ltd.'s shares.

(ii) How A Ltd., will reflect the value of investment in B Ltd., in the Consolidated Financial Statements?

(iii) How the dividend received from B Ltd. will be shown in the Consolidated Financial Statements?

Answer

In terms of AS 23, B Ltd. will be considered as an associate company of A Ltd. as shares acquired represent to more than 20%.

(i) Calculation of Goodwill (*₹ in lakhs)*

Cost of investment	3.00
Less: Share in the value of Equity of BLtd.	
as at the date of investment	
[25% of ₹ 10 lakhs (₹ 5 lakhs + ₹ 5 lakhs)]	(2.50)
Goodwill	0.50

(ii)

A Ltd.
Consolidated Profit and Loss Account
for the year ended 31st March, 2017 (An extract)

		₹ in lakhs
Other income:		
Share of profits in B Ltd.		1.75
Dividend received from B Ltd.	0.50	
Transfer to investment A/c	(0.50)	Nil

(iii)

A Ltd.
Consolidated Balance Sheet as on 31.3.2017 (An extract)

		₹ in lakhs
Non-current investments		
Investment in B Ltd.		
Share in B Ltd.'s Equity	2.50	
Less: Dividend received	(0.50)	
	2.00	
Share of profit for year 2016 – 2017	1.75	
	3.75	
Add: Goodwill	0.50	4.25

Working Notes:

1. Dividend received from B Ltd. amounting to ₹ 0.50 lakhs will be reduced from investment value in the books of A Ltd. However goodwill will not change.
2. B Ltd. made a profit of ₹ 7 lakhs for the year ended 31st March, 2017. A Ltd.'s share in the profits of ₹ 7 lakhs is ₹ 1.75 lakhs. Investment in B Ltd. will be increased by ₹ 1.75

lakhs and consolidated profit and loss account of A Ltd. will be credited with ₹ 1.75 lakhs in the consolidated financial statement of A Ltd.

3. Dividend declared on 30th April, 2017 will not be recognized in the consolidated financial statements of A Ltd.

Question 93

Bright Ltd. acquired 30% of East India Ltd. shares for ₹ 2,00,000 on 01-06-14. By such an acquisition Bright can exercise significant influence over East India Ltd. During the financial year ending on 31-03-14 East India earned profits ₹ 80,000 and declared a dividend of ₹ 50,000 on 12-08-2016. East India reported earnings of ₹ 3,00,000 for the financial year ending on 31-03-15 and declared dividends of ₹ 60,000 on 12-06-2017.

Calculate the carrying amount of investment in:

(i) Separate financial statements of Bright Ltd. as on 31-03-15;

(ii) Consolidated financial statements of Bright Ltd.; as on 31-03-15;

(iii) What will be the carrying amount as on 30-06-2017 in consolidated financial statements?

Answer

(i) Carrying amount of investment in Separate Financial Statement of Bright Ltd. as on 31.03.15

	₹
Amount paid for investment in Associate (on 1.06.2016)	2,00,000
Less: Pre-acquisition dividend (₹ 50,000 x 30%)	(15,000)
Carrying amount as on 31.3.2017 as per AS 13	1,85,000

(ii) Carrying amount of investment in Consolidated Financial Statements* of Bright Ltd. as on 31.3.2017 as per AS 23

	₹
Carrying amount as per separate financial statements	1,85,000
Add: Proportionate share of profit of investee as per equity method (30% of ₹ 3,00,000)	90,000
Carrying amount as on 31.3.2017	2,75,000

*It is assumed that Bright Ltd. has a subsidiary company and it is preparing Consolidated Financial Statements.

(iii) Carrying amount of investment in Consolidated Financial Statement of Bright Ltd. as on 30.6.2017 as per AS 23

	₹
Carrying amount as on 31.3.2017	2,75,000
Less: Dividend received (₹ 60,000 x 30%)	(18,000)
Carrying amount as on 30.6.2017	2,57,000

Accounting Standard 24

Question 94

(i) What are the disclosure and presentation requirements of AS 24 for discontinuing operations?

(ii) Give four examples of activities that do not necessarily satisfy criterion (a) of paragraph 3 of AS 24, but that might do so in combination with other circumstances.

Answer

(i) An enterprise should include the following information relating to a discontinuing operation in its financial statements beginning with the financial statements for the period in which the initial disclosure event (as defined in paragraph 15) occurs:

(a) a description of the discontinuing operation(s);

(b) the business or geographical segment(s) in which it is reported as per AS 17, Segment Reporting;

(c) the date and nature of the initial disclosure event;

(d) the date or period in which the discontinuance is expected to be completed if known or determinable;

(e) the carrying amounts, as of the balance sheet date, of the total assets to be disposed of and the total liabilities to be settled;

(f) the amounts of revenue and expenses in respect of the ordinary activities attributable to the discontinuing operation during the current financial reporting period;

(g) the amount of pre-tax profit or loss from ordinary activities attributable to the discontinuing operation during the current financial reporting period, and the income tax expense related thereto; and

(h) the amounts of net cash flows attributable to the operating, investing, and financing activities of the discontinuing operation during the current financial reporting period.

(ii) Para 3 of AS 24 "Discontinuing Operations" explains the criteria for determination of discontinuing operations. According to Paragraph 9 of AS 24, examples of activities that do not necessarily satisfy criterion (a) of paragraph 3, but that might do so in combination with other circumstances, include:

(i) Gradual or evolutionary phasing out of a product line or class of service;

(ii) Discontinuing, even if relatively abruptly, several products within an ongoing line of business;

(iii) Shifting of some production or marketing activities for a particular line of business from one location to another; and

(iv) Closing of a facility to achieve productivity improvements or other cost savings.

An example in relation to consolidated financial statements is selling a subsidiary whose activities are similar to those of the parent or other subsidiaries.

Accounting Standard 25

Question 95

In view of the provisions of Accounting Standard 25 on Interim Financial Reporting, on what basis will you calculate, for an interim period, the provision in respect of defined benefit schemes like pension, gratuity etc. for the employees?

Answer

Accounting Standard 25 suggests that provision in respect of defined benefit schemes like pension and gratuity for an interim period should be calculated based on the year-to-date basis by using the actuarially determined rates at the end of the prior financial year, adjusted for significant market fluctuations since that time and for significant curtailments, settlements or other significant one-time events.

Question 96

On 30.6.2016, Asmitha Ltd. incurred ₹ 2,00,000, net loss from disposal of a business segment. Also, on 30.7.2016, the company paid ₹ 60,000 for property taxes assessed for the calendar year 2016. How the above transactions should be included in determination of net income of Asmitha Ltd. for the six months interim period ended on 30.9.2016.

Answer

According to Para 10 of AS 25 "Interim Financial Reporting", if an enterprise prepares and presents a complete set of financial statements in its interim financial report, the form and content of those statements should conform to the requirements as applicable to annual complete set of financial statements. As on 30.9.2016, As mitha Ltd., would report the entire ₹ 2,00,000 loss on the disposal of its business segment since the loss was incurred during interim period. A cost charged as an expense in an annual period should be allocated to Interim periods on accrual basis. Since ₹ 60,000 Property Tax payment relates to entire calendar year 2016, ₹ 30,000 would be reported as an expense for six months ended on 30th September, 2016 while out of the remaining ₹ 30,000, ₹ 15,000for January, 2016 to March, 2016 should be shown as payment of the outstanding amount of previous year and another ₹ 15,000 related to quarter October, 2016 to December, 2016 would be reported as prepaid expenses.

Question 97

An enterprise reports quarterly, estimates an annual income of ₹ 10 lakhs. Assume tax rates on 1st ₹ 5,00,000 at 30% and on the balance income at 40%. The estimated quarterly income are ₹ 75,000, ₹ 2,50,000, ₹ 3,75,000 and ₹ 3,00,000.

Calculate the tax expense to be recognized in each quarter.

Answer

As per para 29 of AS 25 'Interim Financial Reporting', income tax expense is recognised in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full financial year.

		₹
Estimated Annual Income	(A)	10,00,000
Tax expense:		
30% on ₹ 5,00,000		1,50,000
40% on remaining ₹ 5,00,000		2,00,000
	(B)	3,50,000

Weighted average annual income tax rate = $\frac{B}{A} = \frac{3,50,000}{10,00,000}$ = 35%

Tax expense to be recognised in each of the quarterly reports	₹
Quarter I - ₹ 75,000 x 35%	26,250
Quarter II - ₹ 2,50,000 x 35%	87,500
Quarter III - ₹ 3,75,000 x 35%	1,31,250
Quarter IV - ₹ 3,00,000 x 35%	1,05,000
₹ 10,00,000	3,50,000

Question 98

On 30-6-2016, X Limited incurred ₹ 3,00,000 net loss from disposal of a business segment. Also on 31-7-2016, the company paid ₹ 80,000 for property taxes assessed for the calendar year 2016. How should the above transactions be included in determination of net income of X Limited for the six months interim period ended on 30-9-2016?

Answer

Para 28 of AS 25 "Interim Financial Reporting" states that revenues and gains should be recognised in interim reports on the same basis as used in annual reports. As at September 30, 2016, X Ltd. would report the entire ₹ 3,00,000 loss on the disposal of its business segment since the loss was incurred during the interim period.

A cost charged as an expense in an annual period should be allocated among the interim periods, which are clearly benefited from the expense, through the use of accruals and/or deferrals. Since ₹ 80,000 property tax payment relates to the entire 2016 calendar year, only ₹ 40,000 of the payment would be reported as an expense at September 30, 2016, while out of the remaining ₹ 40,000, ₹ 20,000 for Jan. 2016 to March, 2016 would be shown as payment of the outstanding amount of previous year and another ₹ 20,000 related to quarter October, 2016 to December, 2016, would be reported as a prepaid expense.

Question 99

Antarbarti Limited reported a Profit Before Tax (PBT) of ₹ 4 lakhs for the third quarter ending 30-09-2016. On enquiry you observe the following. Give the treatment required under AS 25:

(i) Dividend income of ₹ 4 lakhs received during the quarter has been recognized to the extent of ₹ 1 lakh only.

(ii) 80% of sales promotion expenses ₹ 15 lakhs incurred in the third quarter has been deferred to the fourth quarter as the sales in the last quarter is high.

(iii) In the third quarter, the company changed depreciation method from WDV to SLM, which resulted in excess depreciation of ₹ 12 lakhs. The entire amount has been debited in the third quarter, though the share of the third quarter is only ₹ 3 lakhs.

(iv) ₹ 2 lakhs extra-ordinary gain received in third quarter was allocated equally to the third and fourth quarter.

(v) Cumulative loss resulting from change in method of inventory valuation was recognized in the third quarter of ₹ 3 lakhs. Out of this loss ₹ 1 lakh relates to previous quarters.

(vi) Sale of investment in the first quarter resulted in a gain of ₹ 20 lakhs. The company had apportioned this equally to the four quarters.

Prepare the adjusted profit before tax for the third quarter.

Answer

As per para 36 of AS 25 "Interim Financial Reporting", seasonal or occasional revenue and cost within a financial year should not be deferred as of interim date untill it is appropriate to defer at the end of the enterprise's financial year. Therefore, dividend income, extra-ordinary gain, and gain on sale of investment received during 3rd quarter should be recognised in the 3rd quarter only. Similarly, sales promotion expenses incurred in the 3rd quarter should also be charged in the 3rd quarter only.

Further, as per the standard, if there is change in the accounting policy within the current financial year, then such a change should be applied retrospectively by restating the financial statements of prior interim periods of the current financial year. The change in the method of depreciation or inventory valuation is a change in the accounting policy. Therefore, the prior interim periods' financial statements should be restated by applying the change in the method of valuation retrospectively.

Accordingly, the adjusted profit before tax for the 3rd quarter will be as follows:

Statement showing Adjusted Profit Before Tax for the third quarter

	(₹ in lakhs)
Profit before tax (as reported)	4
Add: Dividend income ₹ (4-1) lakhs	3
Excess depreciation charged in the 3rd quarter, due to change in the method, should be applied retrospectively ₹ (12-3) lakhs	9
Extra ordinary gain ₹ (2-1) lakhs	1
Cumulative loss due to change in the method of inventory valuation should be applied retrospectively ₹ (3-2) lakhs	1
	18
Less: Sales promotion expenses (80% of ₹ 15 lakhs)	(12)
Gain on sale of investment (occasional gain should not be deferred)	(5)
Adjusted Profit before tax for the third quarter	1

Accounting Standard 26

Question 100

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 2016-2017, but proved to be a failure.

State, how you will deal with this amount in the accounts of U Ltd. for the year ended 31st March, 2017 with reference to Accounting Standards:

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.

Question 101

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.

Question 102

U.K. International Ltd. is developing a new production process. During the financial year ending 31st March, 2016, the total expenditure incurred was ₹ 50 lakhs. This process met the criteria for recognition as an intangible asset on 1st December, 2015. Expenditure incurred till this date was ₹ 22 lakhs. Further expenditure incurred on the process for the financial year ending 31st March, 2017 was ₹ 80 lakhs. As at 31st March, 2017, the recoverable amount of know-how embodied in the process is estimated to be ₹ 72 lakhs. This includes estimates of future cash outflows as well as inflows.

You are required to calculate:

(i) Amount to be charged to Profit and Loss A/c for the year ending 31st March, 2016 and carrying value of intangible as on that date.

(ii) Amount to be charged to Profit and Loss A/c and carrying value of intangible as on 31st March, 2017.

Ignore depreciation.

Answer

As per AS 26 'Intangible Assets'

(i) For the year ending 31.03.2016

(1) Carrying value of intangible as on 31.03.2016:

At the end of financial year 31st March 2016, the production process will be recognized (i.e. carrying amount) as an intangible asset at a cost of ₹ 28 lakhs (expenditure incurred since the date the recognition criteria were met, i.e., from 1st December 2015).

(2) Expenditure to be charged to Profit and Loss account:

The ₹ 22 lakhs is recognized as an expense because the recognition criteria were not met until 1st December 2016. This expenditure will not form part of the cost of the production process recognized in the balance sheet.

(ii) For the year ending 31.03.2017

(1) Expenditure to be charged to Profit and Loss account:

	(₹ in lakhs)
Carrying Amount as on 31.03.2016	28
Expenditure during 2016 – 2017	80
Total book cost	108
Recoverable Amount	(72)
Impairment loss	36

₹ 36 lakhs to be charged to Profit and loss account for the year ending 31.03.2017.

(2) Carrying value of intangible as on 31.03.2017:

	(₹ in lakhs)
Total Book Cost	108
Less: Impairment loss	(36)
Carrying amount as on 31.03.2017	72

Accounting Standard 27

Question 103

What are the different forms of joint ventures? Elucidate the presentation and disclosure norms of Joint Ventures under AS 27.

Answer

Joint ventures take many different forms and structures. This Standard identifies three broad types – jointly controlled operations, jointly controlled assets and jointly controlled entities – which are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

(a) two or more venturers are bound by a contractual arrangement; and

(b) the contractual arrangement establishes joint control.

A venturer should disclose the aggregate amount of the following contingent liabilities, unless the probability of loss is remote, separately from the amount of other contingent liabilities:

(a) any contingent liabilities that the venturer has incurred in relation to its interests in joint ventures and its share in each of the contingent liabilities which have been incurred jointly with other venturers;

(b) its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable; and

(c) those contingent liabilities that arise because the venturer is contingently liable for the liabilities of the other venturers of a joint venture.

A venturer should disclose the aggregate amount of the following commitments in respect of its interests in joint ventures separately from other commitments:

(a) any capital commitments of the venturer in relation to its interests in joint ventures and its share in the capital commitments that have been incurred jointly with other venturers; and

(b) its share of the capital commitments of the joint ventures themselves.

A venturer should disclose a list of all joint ventures and description of interests in significant joint ventures. In respect of jointly controlled entities, the venturer should also disclose the proportion of ownership interest, name and country of incorporation or residence.

A venturer should disclose, in its separate financial statements, the aggregate amounts of each of the assets, liabilities, income and expenses related to its interests in the jointly controlled entities.

Accounting Standard 28

Question 104

Write short notes on impairment of asset and its application to inventory.

Answer

The objective of AS 28 'Impairment of Assets' is to prescribe the procedures that an enterprise applies to ensure that its assets are carried at no more than their recoverable amount. An asset is carried at more than its recoverable amount if its carrying amount exceeds the amount to be recovered through use or sale of the asset. If this is the case, the asset is described as impaired and this Standard requires the enterprise to recognize an impairment loss.

- If carrying amount < = Recoverable amount : **Asset is not impaired**
- If carrying amount > Recoverable amount : **Asset is impaired**

Impairment Loss = Carrying Amount – Recoverable Amount

Recoverable amount is the higher of net selling price and its value in use

This standard should be applied in accounting for the impairment of all assets, other than (i) inventories (AS 2, Valuation of Inventories); (ii) assets arising from construction contracts

(AS 7, Accounting for Construction Contracts); (iii) financial assets, including investments that are included in the scope of AS 13, Accounting for Investments; and (iv) deferred tax assets (AS 22, Accounting for Taxes on Income). AS 28 does not apply to inventories, assets arising from construction contracts, deferred tax assets or investments because other accounting standards applicable to these assets already contain specific requirements for recognizing and measuring the impairment related to these assets.

Question 105

Venus Ltd. has a fixed asset, which is carried in the Balance Sheet on 31.3.2017 at ₹ 500 lakhs. As at that date the value in use is ₹ 400 lakhs and the net selling price is ₹ 375 lakhs.

From the above data:

(i) Calculate impairment loss.

(ii) Prepare journal entries for adjustment of impairment loss.

(iii) Show, how impairment loss will be shown in the Balance Sheet.

Answer

(i) Recoverable amount is higher of value in use ₹ 400 lakhs and net selling price ₹ 375 lakhs.

Recoverable amount = ₹ 400 lakhs

Impairment loss = Carried Amount – Recoverable amount

= ₹ 500 lakhs – ₹ 400 lakhs = ₹ 100 lakhs.

(ii) **Journal Entries**

	Particulars	*Dr. Amount (₹ in lakhs)*	*Cr. Amount (₹ in lakhs)*
(i)	Impairment loss account Dr.	100	
	To Asset		100
	(Being the entry for accounting impairment loss)		
(ii)	Profit and loss account Dr.	100	
	To Impairment loss		100
	(Being the entry to transfer impairment loss to profit and loss account)		

(iii) **Balance Sheet of Venus Ltd. as on 31.3.2017**

	(₹ in lakhs)
Fixed Asset	

Asset less depreciation	500
Less: Impairment loss	(100)
	400

Question 106

Good Drugs and Pharmaceuticals Ltd. acquired a sachet filling machine on 1st April, 2016 for ₹ 60 lakhs. The machine was expected to have a productive life of 6 years. At the end of financial year 2016-2017 the carrying amount was ₹ 41 lakhs. A short circuit occurred in this financial year but luckily the machine did not get badly damaged and was still in working order at the close of the financial year. The machine was expected to fetch ₹ 36 lakhs, if sold in the market. The machine by itself is not capable of generating cash flows. However, the smallest group of assets comprising of this machine also, is capable of generating cash flows of ₹ 54 crore per annum and has a carrying amount of ₹ 3.46 crore. All such machines put together could fetch a sum of ₹ 4.44 crore if disposed. Discuss the applicability of Impairment loss.

Answer

As per provisions of Para 91(b) of AS 28 "Impairment of Assets", impairment loss is not to be recognized for a given asset if its cash generating unit (CGU) is not impaired. In the given question, the related cash generating unit which is group of asset to which the damaged machine belongs is not impaired; and the recoverable amount is more than the carrying amount of group of assets. Hence there is no need to provide for impairment loss on the damaged sachet filling machine.

Question 107

From the following details of an asset

(i) Find out impairment loss

(ii) Treatment of impairment loss

(iii) Current year depreciation

Particulars of asset:

Cost of asset	*₹ 56 lakhs*
Useful life period	*10 years*
Salvage value	*Nil*
Current carrying value	*₹ 27.30 lakhs*
Useful life remaining	*3 years*
Recoverable amount	*₹ 12 lakhs*
Upward revaluation done in last year	*₹ 14 lakhs*

Answer

According to AS 28 "Impairment of Assets", an impairment loss on a revalued asset is recognised as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

Impairment Loss and its treatment	₹
Current carrying amount (including revaluation amount of ₹ 14 lakhs)	27,30,000
Less: Current recoverable amount	(12,00,000)
Impairment Loss	15,30,000
Impairment loss charged to revaluation reserve	14,00,000
Impairment loss charged to profit and loss account	1,30,000

After the recognition of an impairment loss, the depreciation (amortization) charge for the asset should be adjusted in future periods to allocate the asset's revised carrying amount, less its residual value (if any), on a systematic basis over its remaining useful life.

In the given case, the carrying amount of the asset will be reduced to ₹ 12,00,000 after impairment. This amount is required to be depreciated over remaining useful life of 3 years (including current year). Therefore, the depreciation for the current year will be ₹ 4,00,000.

Question 108

An asset does not meet the requirements of environment laws which have been recently enacted. The asset has to be destroyed as per the law. The asset is carried in the Balance Sheet at the year end at ₹ 6,00,000. The estimated cost of destroying the asset is ₹ 70,000. How is the asset to be accounted for?

Answer

As per AS 28 "Impairment of Assets", impairment loss is the amount by which the carrying amount of an asset exceeds its recoverable amount, where, recoverable amount is the higher of an asset's net selling price* and its value in use•. In the given case, recoverable amount will be nil [higher of value in use (nil) and net selling price (₹ 70,000)]. Thus impairment loss will be calculated as ₹ 6,00,000 [carrying amount (₹ 6,00,000) – recoverable amount (nil)]. Therefore, asset is to be fully impaired and impairment loss of ₹ 6,00,000 has to be recognized as an expense immediately in the statement of Profit and Loss as per para 58 of AS 28.

Question 109

A plant was acquired 15 years ago at a cost of ₹ 5 crores. Its accumulated depreciation as at 31st March, 2016 was ₹ 4.15 crores. Depreciation estimated for the financial year 2016-2017 is

**<u>Net selling price</u> is the amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable, willing parties, less the costs of disposal. In the given case, Net Selling Price = Selling price – Cost of disposal = Nil – ₹ 70,000 = (₹ 70,000)*

•<u>Value in use</u> is the present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. In the given case, value in use is nil.

₹ 25 lakhs. Estimated Net Selling Price as on 31st March, 2016 was ₹ 30 lakhs, which is expected to decline by 20 per cent by the end of the next financial year.

Its value in use has been computed at ₹ 35 lakhs as on 1st April, 2016, which is expected to decrease by 30 per cent by the end of the financial year.

(i) Assuming that other conditions for applicability of the impairment Accounting Standard are satisfied, what should be the carrying amount of this plant as at 31st March, 2017?

(ii) How much will be the amount of write off for the financial year ended 31st March, 2017?

(iii) If the plant had been revalued ten years ago and the current revaluation reserves against this plant were to be ₹ 12 lakhs, how would you answer to questions (i) and (ii) above?

(iv) If the value in use was zero and the enterprise were required to incur a cost of ₹ 2 lakhs to dispose of the plant, what would be your response to questions (i) and (ii) above?

Answer

As per AS 28 "Impairment of Assets", if the recoverable amount* of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount and that reduction is an impairment loss. An impairment loss on a revalued asset is recognized as an expense in the statement of profit and loss. However, an impairment loss on a revalued asset is recognised directly against any revaluation surplus for the asset to the extent that the impairment loss does not exceed the amount held in the revaluation surplus for that same asset.

In the given case, recoverable amount (higher of asset's net selling price and value in use) will be ₹ 24.5 lakhs on 31.3.2017 according to the provisions of AS 28 [Refer working note].

		(₹ in lakhs)
(i)	Carrying amount of plant (after impairment) as on 31st March, 2017	24.50
(ii)	Amount of write off (impairment loss) for the financial year ended 31st March, 2017 [₹ 60 lakhs – ₹ 24.5 lakhs]	35.50
(iii)	If the plant had been revalued ten years ago	
	Debit to revaluation reserve	12.00
	Amount charged to profit and loss account (₹ 35.50 lakhs – ₹ 12 lakhs)	23.50
(iv)	*If Value in use is zero*	
	Value in use (a)	Nil
	Net selling price (b)	(-)2.00
	Recoverable amount [higher of (a) and (b)]	Nil
	Carrying amount (closing book value)	Nil

*Recoverable amount is the higher of an asset's net selling price and its value in use.

Amount of write off (impairment loss) (₹ 60 lakhs – Nil) Entire book value of plant will be written off and charged to profit and loss account.	60.00

Working Note:

Calculation of Closing Book Value, Estimated Net Selling Value and Estimated Value in Use of Plant at 31st March, 2017.

	(₹ in lakhs)
Opening book value as on 1.4.2016 (₹ 500 lakhs – ₹ 415 lakhs)	85
Less: Depreciation for financial year 2016–2017	(25)
Closing book value as on 31.3.2017	60
Estimated net selling price as on 1.4.2016	30
Less: Estimated decrease during the year (20% of ₹ 30 lakhs)	(6)
Estimated net selling price as on 31.3.2017	24
Estimated value in use as on 1.4.2016	35.0
Less: Estimated decrease during the year (30% of ₹ 35 lakhs)	(10.5)
Estimated value in use as on 31.3.2017	24.5

Question 110

G Ltd., acquired a machine on 1st April, 2010 for ₹ 7 crore that had an estimated useful life of 7 years. The machine is depreciated on straight line basis and does not carry any residual value. On 1st April, 2014, the carrying value of the machine was reassessed at ₹ 5.10 crore and the surplus arising out of the revaluation being credited to revaluation reserve. For the year ended March 2016, conditions indicating an impairment of the machine existed and the amount recoverable ascertained to be only ₹ 79 lakhs. You are required to calculate the loss on impairment of the machine and show how this loss is to be treated in the books of G Ltd. G Ltd., had followed the policy of writing down the revaluation surplus by the increased charge of depreciation resulting from the revaluation.

Answer

Statement Showing Impairment Loss

	(₹ in crores)
Carrying amount of the machine as on 1st April 2010	7.00
Depreciation for 4 years i.e. 2010-2011 to 2013-2014 $\left[\frac{7\text{crores}}{7\text{years}} \times 4\text{years}\right]$	(4.00)
Carrying amount as on 31.03.2014	3.00

Add: Upward Revaluation (credited to Revaluation Reserve account)			2.10
Carrying amount of the machine as on 1st April 2014 (revalued)			5.10
Less: Depreciation for 2 years i.e. 2014-2015 & 2015-2016 $\left[\frac{5.10\text{ crores}}{3\text{ years}} \times 2\text{ years}\right]$			(3.40)
Carrying amount as on 31.03.2016			1.70
Less: Recoverable amount			(0.79)
Impairment loss			0.91
Less: Balance in revaluation reserve as on 31.03.2016:			
Balance in revaluation reserve as on 31.03.2014		2.10	
Less: Enhanced depreciation met from revaluation reserve			
2014-2015 & 2015-2016 =[(1.70 – 1.00) x 2 years]		(1.40)	
Impairment loss set off against revaluation reserve balance as per para 58 of AS 28 "Impairment of Assets"			(0.70)
Impairment Loss to be debited to profit and loss account			0.21

Question 111

X Ltd. purchased a fixed asset four years ago for ₹ 150 lakhs and depreciates it at 10% p.a. on straight line method. At the end of the fourth year, it has revalued the asset at ₹ 75 lakhs and has written off the loss on revaluation to the profit and loss account. However, on the date of revaluation, the market price is ₹ 67.50 lakhs and expected disposal costs are ₹ 3 lakhs. What will be the treatment in respect of impairment loss on the basis that fair value for revaluation purpose is determined by market value and the value in use is estimated at ₹ 60 lakhs?

Answer

Treatment of Impairment Loss

As per para 57 of AS 28 "Impairment of assets", if the recoverable amount (higher of net selling price and its value in use) of an asset is less than its carrying amount, the carrying amount of the asset should be reduced to its recoverable amount. In the given case, net selling price is ₹ 64.50 lakhs (₹ 67.50 lakhs – ₹ 3 lakhs) and value in use is ₹ 60 lakhs. Therefore, recoverable amount will be ₹ 64.50 lakhs. Impairment loss will be calculated as ₹ 10.50 lakhs [₹ 75 lakhs (Carrying Amount after revaluation - Refer Working Note) less ₹ 64.50 lakhs (Recoverable Amount)].

Thus impairment loss of ₹ 10.50 lakhs should be recognised as an expense in the Statement of Profit and Loss immediately since there was downward revaluation of asset which was already charged to Statement of Profit and Loss.

Working Note:

Calculation of carrying amount of the fixed asset at the end of the fourth year on revaluation

	(₹ in lakhs)
Purchase price of a fixed asset	150.00
Less: Depreciation for four years [(150 lakhs / 10 years) x 4 years]	(60.00)
Carrying value at the end of fourth year	90.00
Less: Downward revaluation charged to profit and loss account	(15.00)
Revalued carrying amount	75.00

Accounting Standard 29

Question 112

Mini Ltd. took a factory premises on lease on 1.4.14 for ₹ 2,00,000 per month. The lease is operating lease. During March, 2017, Mini Ltd. relocates its operation to a new factory building. The lease on the old factory premises continues to be live upto 31.12.2019.The lease cannot be cancelled and cannot be sub-let to another user. The auditor insists that lease rent of balance 33 months upto 31.12.2019 should be provided in the accounts for the year ending 31.3.2017. Mini Ltd. seeks your advice.

Answer

In accordance with explanation to para 1(b) of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', if an enterprise has a contract that is onerous, the present obligation under the contract should be recognized and measured as a provision. In the given case, the operating lease contract has become onerous* as the economic benefit of lease contract for next 33 months up to 31.12.2019 will be nil. However, the lessee, Mini Ltd., has to pay lease rent of ₹ 66,00,000 (i.e.2,00,000 p.m. for next 33 months).

Therefore, provision on account of ₹ 66,00,000 is to be provided in the accounts for the year ending 31.03.15. Hence auditor is right.

Question 113

EXOX Ltd. is in the process of finalizing its accounts for the year ended 31st March, 2016. The company seeks your advice on the following:

(i) The Company's sales tax assessment for assessment year 2013-2014 has been completed on 14th February, 2016 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

* 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 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, 2016 whereby the labour union has accepted a revision in wage from June, 2015.The agreement provided that the hike till May, 2016 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, 2016.

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, 2016. 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, 2015 to March, 2016 are required to be provided for in the accounts of the company for the year ended on 31st March, 2016 assuming that the negotiation for revision in wages initiated in the year 2015-2016.

Question 114

Sun Ltd. has entered into a sale contract of ₹ 5 crores with X Ltd. during 2015-2016 financial year. The profit on this transaction is ₹ 1 crore. The delivery of goods to take place during the first month of 2016-2017 financial year. In case of failure of Sun Ltd. to deliver within the schedule, a compensation of ₹ 1.5 crores is to be paid to X Ltd. Sun Ltd. planned to manufacture the goods during the last month of 2015-2016 financial year. As on balance sheet date (31.3.2016), the goods were not manufactured and it was unlikely that Sun Ltd. will be in a position to meet the contractual obligation.

(i) Should Sun Ltd. provide for contingency as per AS 29?

(ii) Should provision be measured as the excess of compensation to be paid over the profit?

Answer

(i) AS 29 "Provisions, Contingent Liabilities and Contingent Assets" provides that when an enterprise has a present obligation, as a result of past events, that probably requires an outflow of resources and a reliable estimate can be made of the amount of obligation, a provision should be recognised. Sun Ltd. has the obligation to deliver the goods within the scheduled time as per the contract. It is probable that Sun Ltd. will fail to deliver the goods within the schedule and it is also possible to estimate the amount of compensation. Therefore, Sun Ltd. should provide for the contingency amounting ₹ 1.5 crores as per AS 29.

(ii) Provision should not be measured as the excess of compensation to be paid over the profit. The goods were not manufactured before 31st March, 2016 and no profit had accrued for the financial year 2015-2016. Therefore, provision should be made for the full amount of compensation amounting ₹ 1.50 crores.

Question 115

An oil company has been contaminating land for several years. It does not clean up because there is no legislation requiring cleaning up. At 31st March 2017, it is virtually certain that a law requiring a clean-up of land already contaminated will be enacted shortly after the year end. Is provisioning presently necessary?

Answer

As per para 29 of AS 29 'Provisions, Contingent Liabilities and Contingent Assets', a past event will lead to present obligation when the enterprise has no realistic alternative to settle the obligation created by the past event.

However, when environmental damage is caused there may be no obligation to remedy the consequences. 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.

In the given case it is virtually certain that law will be enacted requiring clean-up of a land already contaminated. Therefore, an oil company has to provide for such clean-up cost in the year in which the law is virtually certain to be enacted.

Question 116

Vishnu Company has at its financial year ended 31st March, 2017, fifteen law suits outstanding none of which has been settled by the time the accounts are approved by the directors. The directors have estimated the possible outcomes as below:

Result	*Probability*	*Amount of loss*
For first ten cases:		
Win	*0.6*	
Loss-low damages	*0.3*	*90,000*
Loss-high damages	*0.1*	*1,60,000*
For remaining five cases:		
Win	*0.5*	
Loss-low damages	*0.3*	*60,000*
Loss-high damages	*0.2*	*95,000*

The directors believe that the outcome of each case is independent of the outcome of all the others.

Estimate the amount of contingent loss and state the accounting treatment of such contingent loss.

Answer

In the given case, the probability of winning first 10 cases is 60% and for remaining five cases is 50%. In other words, probability of losing 10 cases and 5 cases is 40% and 50% respectively. According to AS 29 "Provisions, Contingent Liabilities and Contingent Assets", where it is not probable that a present obligation exists, an enterprise discloses a contingent liability. Since in the given case, chances of winning the case is more and losing the case is less, no provision will be recognized. In fact, it is a contingent loss / liability.

The amount of contingent loss may be calculated as under:

Expected contingent loss in first ten cases= [₹ 90,000 x 0.3 + ₹ 1,60,000 x 0.1] x 10 cases

= [₹ 27,000 + ₹ 16,000] x 10 cases

= ₹ 43,000 x 10 cases = ₹ 4,30,000

Expected contingent loss in remaining five cases = [₹ 60,000 x 0.3 + ₹ 95,000 x 0.2] x 5 cases

= [₹ 18,000 + ₹ 19,000] x 5 cases

= ₹ 37,000 x 5 cases = ₹ 1,85,000

Total contingent liability = ₹ 4,30,000 + ₹ 1,85,000

= ₹ 6,15,000.

An enterprise should not recognise a contingent liability. For each class of contingent loss / liability at the balance sheet date, an enterprise should disclose, by way of a note, a brief description of the nature of the contingent liability.

Exercise

Question 1

Summarize the recommendations of the Institute of Chartered Accountants of India regarding accounting treatment of excise duty.

Question 2

Briefly indicate the items, which are included in the expression "borrowing cost" as explained in AS 16.

Question 3

A company obtained term loan during the year ended 31st March, 2016 to the extent of ₹ 650 lakhs for modernisation and development of its factory. Buildings worth ₹ 120 lakhs were completed and Plant and Machinery worth ₹ 350 lakhs were installed by 31st March, 2016. A sum of ₹ 70 lakhs has been advanced for Assets the installation of which is expected in the following year. ₹ 110 lakhs has been utilised for Working Capital requirements. Interest paid on the loan of ₹ 650 lakhs during the year 2016-2017 amounted to ₹ 58.50 lakhs. How should the interest amount be treated in the Accounts of the Company?

[Answer: Interest to be capitalized ₹ 48.6 lakhs, Interest to be charged to profit and loss account ₹ 9.9 lakhs]

Question 4

A Limited Company finds that the inventory sheets as on 31.3.2016 had included twice an item the cost of which was ₹ 20,000. You are asked to suggest, how the error would be dealt with in the accounts of the year ended 31.3.2017.

[Answer: ₹ 20,000 should be deducted from opening inventory and ₹ 20,000 should be charged as prior period adjustment in the profit and loss account for the year ended 31st March 2017 in accordance with AS 5 (Revised)]

Question 5

M Ltd. Group has three divisions A, B and C. Details of their turnover, results and net assets are given below:

	(₹ '000)
Division A	
Sales to B	3,050
Other Sales (Home)	60
Export Sales	4,090
	7,200
Division B	
Sales to C	30
Export Sales to Europe	200
	230
Division C	
Export Sales to America	180

Divisions

	Head Office ₹ ('000)	A ₹ ('000)	B ₹ ('000)	C ₹ ('000)
Operating Profit or Loss before tax		160	20	(8)
Re-allocated cost from Head Office		48	24	24
Interest cost		4	5	1
Fixed assets	50	200	40	120
Net current assets	48	120	40	90
Long-term liabilities	38	20	10	120

Prepare a Segmental Report for publication in M Ltd. Group.

Question 6

Arrange and redraft the following Cash Flow Statement in proper order keeping in mind the requirements of AS 3:

		(₹ in lacs)	(₹ in lacs)
Net Profit			60,000
Add:	Sale of Investments	70,000	
	Depreciation on Assets	11,000	
	Issue of Preference Shares	9,000	
	Loan raised	4,500	
	Decrease in Inventory	12,000	1,06,500
			1,66,500
Less:	Purchase of Fixed Assets	65,000	
	Decrease in trade payables	6,000	
	Increase in Trade receivables	8,000	
	Exchange gain	8,000	
	Profit on sale of investments	12,000	
	Redemption of Debenture	5,700	
	Dividend paid	1,400	
	Interest paid	945	(1,07,045)
			59,455
Add:	Opening cash and cash equivalent		12,341
Closing cash and cash equivalent			71,796

[Answer: Net cash from operating activities ₹ 49,000 lakhs, Net cash from Investing activities ₹ 5,000 lakhs , Net cash from financing activities ₹ 5,455 lakhs]

Question 7

Lessee Ltd. took a machine on lease from Lessor Ltd., the fair value being ₹ 7,00,000. The economic life of the machine as well as the lease term is 3 years. At the end of each year Lessee Ltd. pays ₹ 3,00,000. Guaranteed Residual Value (GRV) is ₹ 22,000 on expiry of the lease. Implicit Rate of Return (IRR) is 15% p.a. and present value factors at 15% are 0.869, 0.756 and 0.657 at the end of first, second and third years respectively.

Calculate the value of machine to be considered by Lessee Ltd. and the interest (Finance charges) in each year.

[Answer: Value of machine will be taken as ₹ 6,99,054; Finance charges- year 1 ₹ 1,04,858, year 2 ₹ 75,587, year 3 ₹ 41,925]

Question 8

A Cosmetic articles producing company provides the following information:

	Cold Cream	Vanishing Cream
January, 2016 – September, 2016 per month	2,00,000	2,00,000
October, 2016 – December, 2016 per month	1,00,000	3,00,000
January, 2017- March, 2017 per month	0	4,00,000

The company has enforced a gradual change in product-line on the basis of an overall plan. The Approving Authority of the company has passed a resolution in March, 2017 to this effect. The company follows calendar year as its accounting year. Should this be treated as a discontinuing operation? Give reasons in support of your answer.

[Answer: Change-over is not a discontinuing operation]

2

Indian Accounting Standards (Ind AS)

BASIC CONCEPTS

Indian Accounting Standards (Ind-AS) are the International Financial Reporting Standards (IFRS) converged standards issued by the Central Government of India under the supervision and control of Accounting Standards Board (ASB) of ICAI and in consultation with National Advisory Committee on Accounting Standards (NACAS). Ind AS are considered a "principles-based" set of standards. In fact, they establish broad rules rather than dictating specific treatments.

While formulating IFRS-converged Indian Accounting Standards (Ind AS), efforts have been made to keep these Standards, as far as possible, in line with the corresponding IAS/IFRS and departures have been made where considered absolutely essential. These changes have been made considering various factors, such as

- Various terminology related changes have been made to make it consistent with the terminology used in law, e.g., 'statement of profit and loss' in place of 'statement of comprehensive income' and 'balance sheet' in place of 'statement of financial position'.
- Removal of options in accounting principles and practices in Ind AS vis-a-vis IFRS, have been made to maintain consistency and comparability of the financial statements to be prepared by following Ind AS. However, these changes will **not result into carve outs.**
- Certain changes have been made considering the economic environment of the country, which is different as compared to the economic environment presumed to be in existence by IFRS. These differences are due to differences in application of accounting principles and practices and economic conditions prevailing in India. These diffferences which are in deviation to the accounting principles and practices stated in IFRS, are commonly known as **'Carve-outs'.**

In Ind AS 103 "Business Combination", an additional guidance on "Accounting of Business Combinations of Entities under Common Control" is given which is over and above what is given in IFRS. This is termed as **'Carve-in'.**

Roadmap for Implementation of Indian Accounting Standards (Ind AS)

A. For Companies other than banks, NBFCs and Insurance Companies

1st April 2015 or thereafter: Voluntary Basis for all companies
(with Comparatives)

Phase I **1st April 2016: Mandatory Basis**

(a) Companies listed/in process of listing on Stock Exchanges in India or Outside India having net worth ≥ INR 5 Billion

(b) Unlisted Companies having net worth ≥ INR 5 Billion

(c) Parent, Subsidiary, Associate and J.V. of Above

Phase II **1st April 2017: Mandatory Basis**

(a) All companies which are listed/or in process of listing inside or outside India on Stock Exchanges not covered in Phase I (other than companies listed on SME Exchanges)

(b) Unlisted companies having net worth INR 5 Billion > INR 2.5 Billion

(c) Parent, Subsidiary, Associate and J.V. of Above

- Companies listed on SME exchange not required to apply Ind AS.
- Once Ind ASs are applicable, an entity shall be required to follow the Ind AS for all the subsequent financial statements.
- Companies not covered by the above roadmap shall continue to apply existing Accounting Standards notified in Companies (Accounting Standards) Rules, 2006.

B. For Scheduled Commercial Banks (Excluding RRBs), Insurers/Insurance Companies and Non-Banking Financial Companies (NBFC's)

Non-Banking Financial Companies (NBFC's)	
Phase I:	**From 1st April, 2018 (with comparatives)**
	• NBFCs (whether listed or unlisted) having net worth 500 crore or more
	• Holding, Subsidiary, JV and Associate companies of above NBFC other than those already covered under corporate roadmap shall also apply from said date

Phase II:	From 1st April, 2019 (with comparatives)
	• NBFCs whose equity and/or debt securities are listed or are in the process of listing on any stock exchange in India or outside India and having net worth less than 500 crore.
	• NBFCs that are unlisted having net worth 250 crore or more but less 500 crore.
	• Holding, Subsidiary, JV and Associate companies of above other than those already covered under corporate roadmap shall also apply from said date.
• Applicable for both Consolidated and individual Financial Statements	
• NBFC having net worth below 250 crore shall not apply Ind AS.	
• Adoption of Ind AS is allowed only when required as per the roadmap.	
• Voluntary adoption of Ind AS is not allowed.	
Scheduled Commercial banks (excluding RRB's) and Insurers/Insurance companies	
➢ **From 1st April, 2018 (with comparatives):**	
• Holding, subsidiary, JV and Associates companies of scheduled commercial banks (excluding RRB's) shall also apply from the said date irrespective of it being covered under corporate roadmap.	
• Applicable for both Consolidated and individual Financial Statements	
➢ **Urban Cooperative banks (UCBs) and Regional Rural banks (RRBs) are not required to apply Ind AS.**	

Question 1

Briefly explain the following terms:

(i) Other comprehensive income

(ii) Prior period errors

(iii) Types of leases

Answer

(i) Other comprehensive income comprises items of income and expenses (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other Ind ASs.

The Standard requires an entity to disclose reclassification adjustments and income tax relating to each component of other comprehensive income. Reclassification adjustments are the amounts reclassified to profit or loss in the current period that were previously recognised in other comprehensive income.

The other comprehensive income section shall present line items for amounts for the period of:

(a) items of other comprehensive income (excluding amounts in paragraph (b)), classified by nature and grouped into those that, in accordance with other Ind AS:

   (i) will not be reclassified subsequently to profit or loss; and

   (ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(b) the share of the other comprehensive income of associates and joint ventures accounted for using the equity method, separated into the share of items that in accordance with other Ind AS:

   (i) will not be reclassified subsequently to profit or loss; and

   (ii) will be reclassified subsequently to profit or loss when specific conditions are met.

(ii) Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

was available when financial statements for those periods were approved for issue; and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of:

(a) mathematical mistakes,

(b) mistakes in applying accounting policies,

(c) oversights or

(d) misinterpretations of facts, and

(e) fraud.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Except to the extent that it is impracticable to determine either the period-specific effects or the cumulative effect of the error, the Standard requires to correct material prior period errors retrospectively in the first set of financial statements approved for issue after their discovery by:

(a) restating the comparative amounts for the prior period(s) presented in which the error occurred; or

(b) if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented.

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

(iii) 1. Finance Lease: A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Risks include the possibilities of losses from idle capacity or technological obsolescence and of variations in return because of changing economic conditions.

Rewards may be represented by the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realisation of a residual value.

Title may or may not eventually be transferred.

2. Operating Lease: An operating lease is a lease other than a finance lease.

3. Non-cancellable Lease: A non-cancellable lease is a lease that is cancellable only:

(a) upon the occurrence of some remote contingency;

(b) with the permission of the lessor;

(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 such an additional amount that, at inception of the lease, continuation of the lease is reasonably certain.

Question 2

Write short notes on types of Employee Benefits:

Answer

Employee benefits include:

(a) Short-term Employee Benefits: Short-term employee benefits are employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related services. It includes:

(i) wages, salaries and social security contributions;

(ii) paid annual leave and paid sick leave;

(iii) profit-sharing and bonuses; and

(iv) non-monetary benefits (such as medical care, housing, cars and free or subsidised goods or services) for current employees;

(b) Post-employment Benefits: Post-employment benefits are employee benefits (other than termination benefits and short-term employee benefits) that are payable after the completion of employment. Post-employment benefit plans are formal or informal arrangements under which an entity provides post-employment benefits for one or more employees, such as the following:

(i) retirement benefits (e.g. pensions and lump sum payments on retirement); and

(ii) other post-employment benefits, such as post-employment life insurance and post-employment medical care;

(c) Other Long-term Employee Benefits: Other long-term employee benefits are all employee benefits other than short-term employee benefits, post-employment benefits and termination benefits, such as the following:

(i) long-term paid absences such as long-service leave or sabbatical leave;

(ii) jubilee or other long-service benefits; and

(iii) long-term disability benefits; and

(d) Termination Benefits: Termination benefits are employee benefits provided in exchange for the termination of an employee's employment.

Question 3

Cost of a machine acquired on 01.04.2013 was ₹ 5,00,000. The machine is expected to realize ₹ 50,000 at the end of its working life of 10 years. Straight-line depreciation of ₹ 45,000 per year has been charged upto 2015-2016. From 2016-17, the company switched over to 15% p.a. reducing balance method of depreciation in respect of the machine. The new rate of depreciation is based on revised useful life of 15 years. State how would you deal with the above in the annual accounts of the Company for the year ended 31st March, 2017 in light of Ind AS 8.

Answer

A change in the method of depreciation, as also a change in the useful life of an asset, are to be accounted for as a change in Accounting Estimates (Ind AS 16: Property, Plant and Equipment)

A change in an accounting estimate is to be given effect to on a prospective basis as per Ind AS 8 (Accounting Policies, Changes in Accounting Estimates and Errors)

In terms of Ind AS 8, the effect of change in an accounting estimate, shall be recognised prospectively by including it[1] in profit or loss in the following cases.

[1] In this context, the word "It" means, the revision in the estimated amount.

The period of the change, if the change affects that period only; or

The period of the change and future periods, if the change affects both.

A change in the method of depreciation, as also a change in the estimated useful life of a depreciable asset affects depreciation expense for the current period and in each future period during the asset's remaining revised useful life.

The effect of the change relating to the current period is included as expense in the current period. The effect, if any, on future periods is also to be similarly included in P&L as an item of expense in those future periods.

Thus, the following accounting treatment and disclosures will be appropriate:

Step 1 : Computation of carrying amount of asset at the time of change (in ₹)

Original Cost (A)	Annual depreciation for three years so far (B)	Carrying amount (A – B)
5,00,000	135,000 (being 45,000 x 3)	3,65,000

Book Value of the Asset at the end 2015-16: ₹ 3,65,000.

Step 2 : Change in the method of depreciation and useful life occurred from 2016-17

There is also a consequential change in RV. The effect of these changes results in an increase in the estimated amount of depreciation. The revised estimated amount of depreciation for the year 2016-17 is ₹ 54,750 as shown below:

(in ₹)

Carrying amount at the time of change(A)	The effect of changes resulting in increased depreciation is (B)	Carrying amount A minus B
3,65,000	54,750	3,10,250
	(being 15% of 365,000)	

Step 3: The effect of change is an increased depreciation of ₹ 54,750. Therefore, the amount to be included in the Statement of Profit and Loss for the year ended 2016-17 is ₹ 54,750

Step 4: Disclosures prescribed in Ind AS 8 are:

An entity shall disclose the nature and amount of a change in an accounting estimate that has an effect in the current period or is expected to have an effect in future periods, except for the disclosure of the effect on future periods when it is impracticable to estimate that effect.

Disclosures in the year of change would be.

1. **Under Significant Accounting Policies:** Effective current reporting period, the entity has adopted WDV method of depreciation in place of straight line method followed earlier, and has also changed the estimated useful life of the asset to 15 years, thus increasing the revised remaining useful life to 12 years (PY 7 years). These changes, and the resultant change in RV, are based on technical evaluation.

2. **As part of Notes to the Statement of Profit and Loss: Consequent to the change in depreciation method from WDV to SLM, the amount of depreciation allocable to the current accounting period has been re-computed at ₹ 54,750 and this sum has been included in the Statement of Profit and Loss (Previous year 45,000).**

Question 4

Write short note on some key differences between Ind AS and Existing AS with respect to:

(a) Property, Plant and Equipment

(b) Changes in Accounting Policy and Prior period items.

(c) Inventories.

Answer

(a) Property, Plant and Equipment

(i) ***Fixed Assets retired from Active Use and Held for Sale:*** Ind AS 16 does not deal with the assets 'held for sale' because the treatment of such assets is covered in Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations. Existing AS 10 deals with accounting for items of fixed assets retired from active use and held for sale.

(ii) ***Stripping Costs in the Production Phase of a Surface Mine:*** Ind AS 16 provides guidance on measuring 'Stripping Costs in the Production Phase of a Surface Mine'. Existing AS does not contain this guidance.

(b) Changes in Accounting Policy and Prior period items

(i) ***Objective*:** Objective of existing AS 5 is to prescribe the classification and disclosure of certain items in the statement of profit and loss for uniform preparation and presentation of financial statements. Objective of Ind AS 8 is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and corrections of errors. Ind AS 8 intends to enhance the relevance and reliability of an entity's financial statements and the comparability of those financial statements over time and with the financial statements of other entities.

(ii) ***Extraordinary Items***: Keeping in view that Ind AS 1, '*Presentation of Financial Statements'*, prohibits the presentation of any items of income or expense as extraordinary items, Ind AS 8 does not deal with the same.

(iii) ***Definition of Accounting Policies***: Existing AS 5 restricts the definition of accounting policies to specific accounting principles and the methods of applying those principles while Ind AS 8 broadens the definition to include bases, conventions, rules and practices (in addition to principles) applied by an entity in the preparation and presentation of financial statements.

(iv) ***Change in Accounting Policies***: In addition to the situations allowed under Ind AS 8 for changing an accounting policy, existing AS 5 allows change in accounting policy if required by statute.

(v) ***Accounting for Changes in Accounting Policies:*** Ind AS 8 specifically states that an entity shall select and apply its accounting policies consistently for similar transactions, other events and conditions, unless an Ind AS specifically requires or permits categorisation of items for which different policies may be appropriate. Neither existing AS 5 nor any other existing Standard specifically requires accounting policies to be consistent for similar transactions, other events and conditions.

(vi) ***Exceptions in Retrospective Accounting of Changes in Accounting Policies:*** Ind AS 8 requires that changes in accounting policies should be accounted for with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy. On the other hand, existing AS 5 does not specify how change in accounting policy should be accounted for.

(vii) ***Prior Period Items***: Existing AS 5 defines prior period items as incomes or expenses which arise in the current period as a result of errors or omissions in the preparation of financial statements of one or more prior periods. Ind AS 8 uses the term 'errors' and relates it to errors or omissions arising from a failure to use or misuse of reliable information (in addition to mathematical mistakes, mistakes in application of accounting policies etc.) that was available when the financial statements of the prior periods were approved for issuance and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Ind AS 8 specifically states that errors include frauds, which is not covered in existing AS 5.

(viii) ***Rectification of Material Prior Period Errors:*** Ind AS 8 requires rectification of material prior period errors with retrospective effect subject to limited exceptions viz., where it is impracticable to determine the period specific effects or the cumulative effect of applying a new accounting policy. On the other hand, existing AS 5 requires the rectification of prior period items with prospective effect.

(c) Inventories

(i) ***Subsequent Recognition:*** Ind AS 2 deals with the subsequent recognition of cost/carrying amount of inventories as an expense, whereas the existing AS 2 does not provide the same.

(ii) ***Inventory of Service Provider:*** Ind AS 2 provides explanation with regard to inventories of service providers whereas the existing AS 2 does not contain such an explanation.

(iii) ***Machinery Spares:*** The existing AS 2 explains that inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10, Property, Plant and Equipment. Such items are accounted for in accordance with Accounting Standard (AS) 10, Property, Plant and Equipment. Ind AS 2 does not contain specific explanation in respect of such spares as this aspect is covered under Ind AS 16.

(iv) ***Inventory held by Commodity Broker-traders:*** Ind AS 2 does not apply to measurement of inventories held by commodity broker-traders, who measure their inventories at fair value less costs to sell. However, this aspect is not there in the existing AS 2.

(v) ***Definition of Fair Value and Distinction Between NRV and Fair Value:*** Ind AS 2 defines fair value and provides an explanation in respect of distinction between 'net realisable value' and 'fair value'. The existing AS 2 does not contain the definition of fair value and such explanation.

(vi) ***Subsequent Assessment of NRV:*** Ind AS 2 provides detailed guidance in case of subsequent assessment of net realisable value. It also deals with the reversal of the write-down of inventories to net realisable value to the extent of the amount of original write-down, and the recognition and disclosure thereof in the financial statements. The existing AS 2 does not deal with such reversal.

(vii) ***Inventories Acquired on Deferred Settlement Terms:*** An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element, for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing.

(viii) ***Exclusion from its Scope but Guidance given:*** Ind AS 2 excludes from its scope only the measurement of inventories held by producers of agricultural and forest products, agricultural produce after harvest, and minerals and mineral products though it provides guidance on measurement of such inventories. However, the existing AS 2 excludes from its scope such types of inventories.

(ix) ***Cost Formulae:*** The existing AS 2 specifically provides that the formula used in determining the cost of an item of inventory should reflect the fairest possible approximation to the cost incurred in bringing the items of inventory to their present location and condition whereas Ind AS 2 does not specifically state so and requires the use of consistent cost formulas for all inventories having a similar nature and use to the entity.

Question 5

Differentiate the following items with reference to Existing Accounting Standards and Ind AS:

(i) Extra ordinary items

(ii) Contingencies.

Answer

Existing Accounting Standards	Ind AS
Extraordinary Items	
Events or transactions, clearly distinct from the ordinary activities of the entity, which are not expected to recur frequently and regularly, are termed as extra-ordinary items. Disclosure of the nature and amount of such item is required in the income statement to perceive the impact of current and future profits.	Ind AS 1 prohibits presentation of any items of income or expense as extraordinary.
Contingencies	
Contingent Liabilities are disclosed unless the probability of outflow is remote. Contingent gains are neither recognized nor disclosed.	Unrecognized possible losses and possible gains are disclosed.

Question 6

Differentiate the following items with reference to Existing Accounting Standards and Ind AS:

(i) Discontinued vs discontinuing operations – definition and measurement

(ii) Acquired intangible assets.

Answer

Treatment under Accounting Standard and IFRS

		Existing Accounting Standards	Ind AS
(i)	**Discontinuing operation - definition and measurement**	In the existing AS 24, there is no concept of discontinued operations but it deals with discontinuing operations. Operations and cash flows that can be clearly distinguished for	Under Ind AS 105, a discontinued operation is a component of an entity that either has been disposed of or is classified as held for

		financial reporting and represent major line of business or geographical area of operations are discontinued operations.	sale.
		The existing AS 24 requires to apply the principles set out in other relevant Accounting Standards, e.g., the existing AS 10 requires that the fixed assets retired from active use and held for disposal should be stated at the lower of their net book value and net realisable value and shown separately in the financial statements.	Under Ind AS 105, non-current assets (disposal groups) held for sale are measured at the lower of carrying amount and fair value less costs to sell, and are presented separately in the balance sheet. However, it also includes a subsidiary acquired exclusively with a view to resale. Discontinued operations are measured at lower of carrying amount and fair value less cost to sell.
(ii)	**Acquired intangible assets**	AS 26 requires that if an intangible asset is acquired in exchange of a non-monetary asset, the principles of AS 10 "Fixed Assets" to be followed i.e. when an asset is acquired in exchange for another asset, its cost is usually determined by reference to the fair market value of the consideration given. It may be appropriate to consider also the fair market value of the asset acquired if this is more clearly evident. An alternative accounting treatment is to record the asset acquired at the net book value of the asset given up; in each case an adjustment is made for any balance receipt or payment of cash or other consideration.	IAS 38 requires that if an intangible asset is acquired in exchange of a non - monetary asset, it should be recognised at the fair value of the asset given up

		As per AS 26, intangible assets acquired free of charge or for nominal consideration by way of government grant is recognised at nominal value or at acquisition cost, as appropriate, plus any expenditure that is attributable to making the asset ready for intended use.	As per IAS 38, when intangible assets are acquired free of charge or for nominal consideration by way of government grant, an entity should, in accordance with IAS 20, record both the grant and the intangible asset at fair value. If an entity chooses not to recognise the asset initially at fair value, the entity may recognise the asset initially at a nominal amount, as per IAS 20, plus any expenditure that is directly attributable to preparing the asset for its intended use.
		There is no such provision in the existing standard.	As per Ind AS 38, in the case of separately acquired intangibles, the criterion of probable inflow of expected future economic benefits is always considered satisfied, even if there is uncertainty about the timing or the amount of the inflow.

Question 7

Differentiate the following items with reference to Existing Accounting Standards and Ind AS:

(a) Impairment of Assets

(b) Business Combinations.

Answer

(a) Impairment of assets

(i) ***Financial Assets:*** Ind AS 36 applies to financial assets classified as subsidiaries, as defined in Ind AS 110, associates as defined in Ind AS 28, joint ventures as defined in Ind AS 111. The existing AS 28 does not apply to the above assets.

(ii) ***Biological Assets:*** Ind AS 36 specifically excludes biological assets related to agricultural activity. Existing AS 28 does not specifically exclude biological assets.

(iii) Impairment Testing for an Intangible Asset with an Indefinite Useful Life: Ind AS 36 requires annual impairment testing for an intangible asset with an indefinite useful life or not yet available for use and goodwill acquired in a business combination. The existing AS 28 does not require the annual impairment testing for the goodwill unless there is an indication of impairment.

(iv) Additional Guidance: Ind AS 36 gives additional guidance on, *inter alia*, the following aspects compared to the existing AS 28:

(a) estimating the value in use of an asset;

(b) for managements to assess the reasonableness of the assumptions on which cash flows are based; and

(c) using present value techniques in measuring an asset's value in use.

(v) Reversal of Goodwill: The existing AS 28 requires that the impairment loss recognised for goodwill should be reversed in a subsequent period when it was caused by a specific external event of an exceptional nature that is not expected to recur and subsequent external events that have occurred that reverse the effect of that event whereas Ind AS 36 prohibits the recognition of reversals of impairment loss for goodwill.

(vi) Bottom up and Top Down Test: In the existing AS 28, goodwill is allocated to CGUs only when the allocation can be done on a reasonable and consistent basis. If that requirement is not met for a specific CGU under review, the smallest CGU to which the carrying amount of goodwill can be allocated on a reasonable and consistent basis must be identified and the impairment test carried out at this level. Thus, when all or a portion of goodwill cannot be allocated reasonably and consistently to the CGU being tested for impairment, two levels of impairment tests are carried out, viz., bottom-up test and top-down test.

In Ind AS 36, goodwill is allocated to cash-generating units (CGUs) or groups of CGUs that are expected to benefit from the synergies of the business combination from which it arose. There is no bottom-up or top-down approach for allocation of goodwill.

(viii) Disclosures: Ind AS 36 requires certain extra disclosures as compared to the existing AS 28.

(b) Business Combinations

(i) ***Scope****:* Ind AS 103 defines a business combination which has a wider scope whereas the existing AS 14 deals only with amalgamation.

(ii) ***Methods for Accounting****:* Under the existing AS 14 there are two methods of accounting for amalgamation viz - the pooling of interest method and the purchase method. Ind AS 103 prescribes only the acquisition method for every business combination.

(iii) ***Assets and Liabilities****:* Under the existing AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method. Ind AS 103 requires the acquired identifiable assets liabilities and non-controlling interest to be recognised at fair value under acquisition method.

(iv) ***Minority / Non–controlling****:* Ind AS 103 requires that for each business combination, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets. On other hand, the existing AS 14 states that the minority interest is the amount of equity attributable to minorities at the date on which investment in a subsidiary is made and it is shown outside shareholders' equity.

(v) ***Amortisation of Goodwill****:* Under Ind AS 103, the goodwill is not amortised but tested for impairment on annual basis in accordance with Ind AS 36. The existing AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.

(vi) ***Reverse Acquisitions****:* Ind AS 103 deals with reverse acquisitions whereas the existing AS 14 does not deal with the same.

(vii) ***Contingent Consideration****:* Ind AS 103 deals with the contingent consideration in case of business combination, i.e., an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. The existing AS 14 does not provide specific guidance on this aspect.

(viii) ***Bargain Purchase Gain****:* Ind AS 103 requires bargain purchase gain arising on business combination to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. Under existing AS 14 the excess amount is treated as capital reserve.

(ix) ***Accounting for Common Control Transactions****:* Appendix C of Ind AS 103 deals with accounting for common control transactions, which prescribes a method of accounting different from Ind AS 103. Existing AS 14 does not prescribe accounting for such transactions different from other amalgamations.

Question 8

Explain the differences between Ind AS 1 and IAS 1 which results into carve out and which do not result into carve outs.

Answer

Major Changes in Ind AS 1 *vis-à-vis* IAS 1

A. Resulting in Carve outs/carve ins

This carve-out is due to difference in application of accounting principles and practices and economic conditions prevailing in India.

IAS 1 requires that in case of a loan liability, if any condition of the loan agreement which was classified as non-current is breached on the reporting date, such loan liability should be classified as current. Where the breach is rectified after the balance sheet date IAS requires loans to be classified as current.

Carve Out: Ind AS 1 clarifies that where there is a breach of a material provision of a long-term loan arrangement on or before the end of the reporting period with the effect that the liability becomes payable on demand on the reporting date, the entity does not classify the liability as current, if the lender agreed, after the reporting period and before the approval of the financial statements for issue, not to demand payment as a consequence of the breach.

Reason: Under Indian banking system, a long-term loan agreement generally contains a large number of conditions. Some of these conditions are substantive, such as, recalling the loan in case interest is not paid, and some conditions are procedural and not substantive, such as, submission of insurance details where the entity has taken the insurance but not submitted the details to the lender at the end of the reporting period. Generally, customer-banker relationships are developed whereby in case of any procedural breach, a loan is generally not recalled. Also, in many cases, a breach is rectified after the balance sheet date and before the approval of financial statements. Carve out has been made as it is felt that if the breach is rectified after the balance sheet date and before the approval of the financial statements, it would be appropriate that the users are informed about the true nature of liabilities being non-current liabilities and not current liabilities.

B. Not Resulting in Carve outs

1. ***Statement of Profit or Loss:*** With regard to preparation of statement of profit and loss, IAS 1 provides an option either to follow the single statement approach or to follow the two statement approach. An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections or an entity may present the profit or loss section in a separate statement of profit or loss which shall immediately precede the statement presenting comprehensive income beginning with profit or loss.

   Ind AS 1 allows only the single statement approach with profit or loss and other comprehensive income presented in two sections.

2. ***Different Terminology:*** IAS 1 gives the option to individual entities to follow different terminology for the titles of financial statements. Ind AS 1 is changed to remove alternatives by giving one terminology to be used by all entities.

3. ***Periodicity:*** IAS 1 permits the periodicity, for example, of 52 weeks for preparation of financial statements. Ind AS 1 does not permit it.
4. ***Analysis / Classification of Expenses:*** IAS 1 requires an entity to present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the equity. Ind AS 1 requires only nature-wise classification of expenses.
5. ***Materiality:*** IAS 1 requires that items of dissimilar nature or function shall be presented separately unless these are immaterial and paragraph 31 provides that specific disclosure required by IFRS need not be provided if the information is not material. In Ind AS 1, such paragraphs have been modified to include words 'except when required by law'.
6. ***Disclosures regarding Reconciliation:*** Ind AS 1 dealing with disclosures regarding reconciliation between the carrying amount at the beginning and the end of the period for each component of equity, has been amended to include disclosure regarding recognition of bargain purchase gain arising on business combination in line with treatment prescribed in this regard in Ind AS 103.

Question 9

Explain the carve outs in Ind AS 101 from IFRS 1 alongwith the reasons.

Answer

Major Changes in Ind AS 101 Resulting in Carve Outs from IFRS 1

i. ***Definition of Previous GAAP under Ind AS 101:*** IFRS 1 defines previous GAAP as the basis of accounting that a first-time adopter used immediately before adopting IFRS.

   ***Carve out**:* Ind AS 101 defines previous GAAP as the basis of accounting that a first-time adopter used for its reporting requirement in India immediately before adopting Ind ASs. The changes made it mandatory for Indian entities to consider the financial statements prepared in accordance with existing notified Accounting Standards as was applicable to them as previous GAAP when it transitions to Ind ASs.

   ***Reason**:* The change makes it mandatory for Indian companies to consider the financial statements prepared in accordance with existing Accounting Standards notified under the Companies (Accounting Standards) Rules, 2006 as previous GAAP when it transitions to Ind AS as the law prevailing in India recognises the financial statements prepared in accordance with the Companies Act.

(ii) **Allowing the use of Carrying Cost of Property, Plant and Equipment (PPE) on the Date of Transition of Ind AS 101:** IFRS 1 First time adoption of International Accounting Standards provides that on the date of transition either the items of Property, Plant and Equipment shall be determined by applying IAS 16 'Property, Plant and Equipment' retrospectively or the same should be recorded at fair value.

   Carve out: Ind AS 101 provides an additional option to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous

GAAP as an acceptable starting point under Ind AS.

Reason: In case of old companies, retrospective application of Ind AS 16 or fair values at the date of transition to determine deemed cost may not be possible for old assets. Accordingly, Ind AS 101 provides relief to an entity to use carrying values of all items of property, plant and equipment on the date of transition in accordance with previous GAAP as an acceptable starting point under Ind AS.

(iii) ***Long-term Foreign Currency Monetary Items:*** No provision is given in IFRS 1 regarding Long-term Foreign Currency Monetary Items.

Carve out: Ind AS 101 provides that a first-time adopter may continue the policy adopted for accounting for exchange differences arising from translation of long-term foreign currency monetary items recognised in the financial statements for the period ending immediately before the beginning of the first Ind AS financial reporting period as per the previous GAAP. Consequently, Ind AS 21 also provides that it does not apply to long-term foreign currency monetary items for which an entity has opted for the exemption given in Ind AS 101. Such an entity may continue to apply the accounting policy so opted for such long-term foreign currency monetary items.

Reason: AS 11 provides an option to recognise long term foreign currency monetary items in the statement of profit and loss as a part of the cost of property, plant and equipment or to defer its recognition in the statement of profit and loss over the period of loan in case the loan is not related to acquisition of fixed assets. To provide transitional relief, such entities have been given an option to continue the capitalisation or deferment of exchange differences, as the case may be, on foreign currency borrowings obtained before the beginning of First IFRS reporting period.

Question 10

Explain the carve outs in Ind AS 103 from IFRS 3 alongwith the reasons.

Answer

As per IFRS: IFRS 3 requires bargain purchase gain arising on business combination to be recognised in profit or loss as income.

Carve out: Ind AS 103 requires the bargain purchase gain to be recognised in other comprehensive income and accumulated in equity as capital reserve, unless there is no clear evidence for the underlying reason for classification of the business combination as a bargain purchase, in which case, it shall be recognised directly in equity as capital reserve. A similar carve-out is made in Ind AS 28, Investments in Associates and Joint Ventures.

Reasons: At present, since bargain purchase gain occurs at the time of acquiring a business, these are considered as capital reserve. Recognition of such gains in profit or loss would result into recognition of unrealised gains, which may get distributed in the form of dividends. Moreover, such a treatment may lead to structuring through acquisitions, which may not be in the interest of the stakeholders of the company.

3

Corporate Financial Reporting

BASIC CONCEPTS

Financial Reporting

Corporate financial disclosure through published annual reports plays an important role in the efficient allocation of limited resources of a country as most of the investors make their decision based on such fundamental analysis. Adequacy of disclosure cannot be tested accurately and precisely since no definite test to measure it exists in financial reporting. But when information is reported outside the business enterprise, adequacy of disclosure can be tested through questionnaire. The basis of the test is the extent to which the items of information are helpful to users in making economic decision. The quantum and quality of information will vary according the needs of the users. The preparation and publication of a company's annual report on practices and internal structures of corporate governance used by that same company may prove very useful to the shareholders or qualified investors. It may, however, be emphasized that financial reporting does not imply unidirectional and unlimited flow of all kinds of information. How companies can improve their disclosures to investors is an important one as it is perceived by different person in different way. Financial reporting is the communication of financial information of an enterprise to the external world. Measurement and disclosure are two dimensions of reporting process and these two aspects are interrelated. Together, they give corporate reporting its substance.

Corporate accounting Disclosure or financial reporting can be defined as a process through which a business enterprise communicates accounting and financial information with external parties.

A complete set of financial statements normally consists of a Balance Sheet, a Profit & Loss A/c, a Statement of Changes in Equity and a Cash Flow Statement together with notes, statements and other explanatory materials that form integral parts of the financial statements. The component parts of financial statements are interrelated because they reflect different aspects of same transactions or other events.

ICAI Conceptual Framework earmarks four principal qualitative characteristics viz., understandability, relevance, reliability and comparability. **According to the ICAI Conceptual Framework, materiality is not a principal qualitative characteristic.** Materiality is considered as a threshold limit, which needs to be judged before referring to any other qualities of any information provided in financial statements. If any piece of information does not fulfill the threshold criteria, it need not be considered further.

Question 1

What are the main limitations of financial statements?

Answer

Limitations of Financial Statements:

(i) **Financial statements provide mostly historical data and ignore price level changes**: Elements of financial statements, i.e., assets, liabilities, income and expenses are measured mostly using historical cost. So in the balance sheet, most of the assets do not represent their current values. Users of accounts cannot understand the real value of the reporting entity from such balance sheet.

Under the historical cost accounting framework impliedly money capital is maintained - not the real value of capital. Thus the profit and loss statement does not represent real profit/loss. Thus, under inflationary environment, traditional historical cost based financial statement fail to reflect operating result and financial position of the reporting entity.

(ii) **Financial Statements ignore substance and simply recognize form**: In India, financial statements are prepared recognizing legal form of the transactions and ignoring the substance. For example, when the reporting entity uses assets on finance lease basis, value of such assets are not shown in the balance sheet. So the balance sheet fails to show the assets used for revenue generation.

(iii) **Financial statements are essentially based on going concern assumption**: AS 1 'Disclosure of Accounting Policies' suggests that going concern is a fundamental accounting assumption, a departure from which should be disclosed. In practice, the assumption has been applied universally. Even if the reporting entity has become a sick industrial undertaking and waits for BIFR judgement, still its financial statements are prepared following going concern assumption showing its assets and liabilities at historical cost which is highly illogical and totally misleading.

(iv) **Financial statements are over-generalized**: Users of accounts are many; prominent among those are shareholders – existing and potential, employees, lenders and other suppliers, government/regulatory agencies, managers and the public at large. Every section has specific data requirement for making economic decisions. Sometimes the interests of different sections may be conflicting in nature. Financial statements cannot meet the specific data requirement of the users. These are general purpose statements.

(v) **Not free from Bias:** The accountant has to make a choice out of various alternative accounting method e.g., methods of inventory valuation, depreciation, goodwill valuation. Since the subjectivity is inherent in personal judgement, the financial statements are, therefore not free from bias.

(vi) **Variation in Accounting Practices:** As there are variations in accounting practices followed by different firms, a valid comparison of their financial statements is not possible.

(vii) **Qualitative Aspects Ignored:** Financial statements portray the position in monetary terms. Financial statements do not consider nonmonetary aspects like efficiency of management, customer case etc.

(viii) **Ignore the price level changes:** Different assets are shown at the historical cost. It therefore, ignores the price level changes or present value of the assets.

Question 2

Briefly explain the qualitative characteristics of Financial Statements.

Answer

Qualitative characteristics are the attributes that make the information provided in the financial statements useful to the users. The four principal qualitative characteristics are: (i) Understandability, (ii) Relevance, (iii) Reliability and (iv) Comparability.

(i) **Understandability:** An essential, quality of the information provided in the financial statement is that it is readily understandable by the users. For this purpose, users are deemed to have reasonable knowledge of business and economic activities. However, information about complex matters should be included in the financial statements which is relevant to the users of accounts for their economic decision making although this may be too difficult for certain users to understand.

(ii) **Relevance:** To be useful, information must be relevant to the decision making needs of all the users. Information has the quality of relevance when it influences the economic decisions of users by helping them to evaluate past, present or future events or confirming, or correcting their past evaluations.

Relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. In other cases, both the nature and materiality are important.

(iii) **Reliability:** 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.

Reliability of the financial statement information is dependent on faithful representation, substance over form, neutrality, prudence, and completeness. If information is to represent faithfully the transactions and other events, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely by their legal form. To be reliable, the information contained in financial statement must be neutral i.e. 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 pre-determined result or outcome. 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. To be reliable, information in financial statements must also 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.

(iv) **Comparability:** Users must be able to compare the financial statements of an enterprise through time in order to identify trends in its financial position and performance. An important implication of this qualitative characteristic is that users should 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.

Question 3

One of the important factors generally considered for awarding shields and plaques in India for 'Excellence in Financial Reporting' is that the information presented in the accounts make useful disclosures.

What are actually looked into in this regard?

Answer

A financial report of an enterprise is arguably the most important medium of dissemination of such information. With a view to promote better standards in the presentation of information in the financial report, the Institute of Chartered Accountants of India has been holding an annual competition for the ICAI Awards for Excellence in Financial Reporting.

In order to ascertain whether the nature and quality of information presented in the accounts make useful disclosures, the following features are generally looked into:

1. Statement of changes in financial position.
2. Sufficient details of revenues / expenses for financial analysis e.g. distinction between manufacturing cost, selling cost and administration cost.
3. Use of vertical form as against the conventional T form; judicious use of schedules, use of sub-totals, manner of showing comparative figures, ease of getting at figures.
4. To what extent additional financial information is provided to the readers through charts and graphs.
5. Financial highlights and ratios including earnings per share.
6. Inclusion of one or more bits of information like value added statement, break up of operations, organization chart, location of factories / branches, human resource accounting, inflation adjusted accounts, social accounts etc.

Question 4

What are the objectives of financial reporting?

Answer

The following are the objectives of financial reporting:

(i) **Useful Information to Users**-To provide information that is useful to present and potential investors and trade payables and other users in making rational investment, credit, and similar decisions.

(ii) **Assess Prospective Cash Inflows**-To provide information to help investors, trade payables, and others to assess the amount, timing and uncertainly of prospective net cash inflows to the related enterprise.

(iii) **Information about the economic resources of an enterprise** -To provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events and circumstances that change resources and claims to those resources.

(iv) **Financial Performance-** To provide information about an enterprise's financial performance during a period. To give information about an enterprise's performance provided by measures of earnings and its components.

(vi) **Information about Utilization of Cash**- To provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise's resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

(vii) **How Responsibility is Discharged**- To provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it.

(viii) **Decision making**- To provide information that is useful to managers and directors in making decisions in the interest of owners.

Question 5

On 30th September, 2014, Beta Enterprises Ltd. was incorporated with an Authorised Capital of ₹ 50 lakhs. Its first accounts were closed on 31st March, 2015 by which time it had become a listed company with an issued, subscribed and paid up capital of ₹ 40 lakhs in 4,00,000 Equity Shares of ₹ 10 each.

The company started off with two lines of business namely 'Engineering Division' and 'Chemicals Division', with equal asset base with effect from 1st April, 2015. The 'Ceramics Division' was added by the company on 1st April, 2016. The following data is gathered from the books of account of Beta Enterprises Ltd.:

Trial Balance as on 31st March, 2017 *(₹ in 000's)*

	Dr.	Cr.
Engineering Division sales	–	6,000
Cost of Engineering Division sales	2,600	–
Chemicals Division sales	–	8,000
Cost of sales of Chemicals Division	4,300	–
Ceramics Division Sales	–	1,500
Cost of sales of Ceramics Division	900	–
Administration costs	2,000	–
Distribution costs	1,500	–
Dividend-Interim	1,200	–
Dividend Distribution Tax	194.67	
Fixed Assets at cost	9,000	–
Depreciation on Fixed Assets	–	1,500
Inventory on 31st March, 2017	400	–
Trade receivables	246	–
Cash at Bank	159.33	–
Trade payables	–	500
Equity Share Capital in shares of ₹ 10 each	–	4,000
Retained Profits	–	1,000
	22,500	22,500

Additional Information:

(a) *Administration costs should be split between the Divisions in the ratio of 5 : 3 : 2.*

(b) *Distribution costs should be spread over the Divisions in the ratio of 3 : 1 : 1.*

(c) *Directors have declared a Final Dividend of ₹ 800 thousands and desired to transfer 10% of current profits to reserves.*

(d) *Some of the users of Ceramics Division are unhappy with the product and have lodged claims against the company for damages of ₹ 750 thousands. The claim is hotly contested by the company on legal advice.*

(e) *Fixed Assets worth ₹ 3,000 thousands were added in the Ceramics Division on 1.4.2016.*

(f) *Fixed Assets are written off over a period of 10 years on straight line basis in the books. However for Income tax purposes depreciation at 20% on written down value of the assets is allowed by Tax Authorities.*

(g) *Income tax rate may be assumed at 35%.*

(h) *During the year Engineering Division has sold to Alpha Ltd. goods having a sales value of ₹ 2,500 thousands. Mr. Gamma, the Managing Director of Beta Enterprises Ltd. owns 100% of the issued Equity Shares of Alpha Ltd. The sales made to Alpha Ltd. were at normal selling price of Beta Enterprises Ltd.*

You are required to prepare Profit and Loss Account for the year ended 31st March, 2017 and the Balance Sheet as at the date. Your answer should include notes and disclosures as per Accounting Standards.

Answer

Beta Enterprises Ltd.
Profit and Loss Account for the year ending 31st March, 2017

	Particulars		*Note No.*	*(₹ '000)*
I.	Revenue from operations (6,000 + 8,000 + 1,500)			15,500
II.	Total revenue			15,500
III.	Expenses			
	Cost of Sales			(7,800)
	Distribution costs			(1,500)
	Administration costs			(2,000)
	Total expenses			11,300
IV.	Profit before tax			4,200
V.	Tax Expenses			
	Current tax	1,239		
	Deferred tax	231		(1,470)
VI.	Profit or Loss for the period			2,730

Beta Enterprises Ltd.
Balance Sheet as at 31st March, 2017

Particulars	*Note No.*	*(₹ '000)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	4,000.00
(b) Reserves and Surplus	2	1,162.33
(2) Non-Current Liabilities		
Deferred Tax Liability (210 + 231)		441.00

(3) Current Liabilities		
Trade payables		500.00
Other current liabilities	3	963.00
Short term provisions	4	1,239.00
Total		8,305.33
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets	5	7,500.00
(2) Current assets		
(a) Inventories		400.00
(b) Trade receivables		246.00
(c) Cash and cash equivalents		159.33
Total		8,305.33

Notes to Accounts:

		(₹ '000)	(₹ '000)
1.	Share Capital		
	Authorised Share capital		
	5,00,000 Equity shares of ₹ 10 each		5,000.00
	Issued and subscribed		
	4,00,000 shares of ₹ 10 each, fully paid up		4,000.00
2.	Reserves and surplus		
	Retained profit brought forward (1,000 – 210)		790.00
	Profit after tax of the current year	2,730.00	
	Amount transferred to General Reserve (10% of 2,730)	(273.00)	
	Amount transferred to DDT** [(17.304% of 941) +194.67]	(357.67)	
	Dividends (1,200 + 800)	(2,000.00)	
	Profit for the year		99.33

** The dividend distributed by an Indian Company is exempt from income tax in the hands of shareholders. However, the Indian company is liable to pay Dividend Distribution Tax (DDT) @ 17.304% to the Central Government within 14 days from the date of declaration (i.e. inclusive of surcharge and education cess on such dividend). It is assumed that the dividend has already been declared by the company.

	Total Profit		889.33
	Reserves		273.00
			1,162.33
3.	Other Current liabilities		
	Dividend**	800.00	
	Dividend Distribution Tax**	163.00	963.00
4.	Short term provisions		
	Provision for tax		1,239.00
5.	Tangible assets		
	Fixed Assets		
	Gross block	9,000.00	
	Less: Depreciation	(1,500.00)	7,500.00

Disclosures

1. Segmental Disclosures (Business Segments) *(₹ in '000)*

	Engineering Division	*Chemical Division*	*Ceramics division*	*Total*
Sales	6,000	8,000	1,500	15,500
Cost of Sales	2,600	4,300	900	7,800
Administration Cost (5:3:2)	1,000	600	400	2,000
Distribution Cost (3:1:1)	900	300	300	1,500
Profit/Loss	1,500	2,800	(100)	4,200
	6,000	8,000	1,500	15,500
Original cost of Assets (Equal Capital Base)	3,000	3,000	3,000	9,000
Depreciation @ 10% p.a. For the year ended 31.3.2016	300	300	NIL	600
For the year ended 31.3.2017	300	300	300	900

Note: Ceramics division is a reportable segment as per assets criteria.

2. Deferred Tax liability (as per AS 22 on Accounting for Taxes on Income)

	₹ in '000
Opening Timing Difference on 1.4.2016	
WDV of fixed assets as per books	5,400

WDV of fixed assets as per Income Tax Act	4,800
Difference	600
Deferred Tax Liability @ 35% on ₹ 600	210
This has been adjusted against opening balance of retained profits.	
Current year (ended 31st March, 2017)	*(₹ in '000)*
Depreciation as per books	900
Depreciation as per Income Tax Act (₹ 480 + ₹ 480 + ₹ 600)	1,560
Difference	660
Deferred Tax Liability @ 35% on ₹ 660 (to be carried forward)	231

3. **Contingent Liabilities not provided:** Company is contesting claim for damages for ₹ 7,50,000 and as such the same is not acknowledged as debts.

4. **Related Party Disclosure:** Para 3 of AS 18 lists out related party relationships. It includes individuals owning, directly or indirectly, an interest in voting power of reporting enterprise which gives them control or significant influence over the enterprises, and relatives of any such individual. In the instant case, Mr. Gamma as a managing director controls operating and financial actions of Beta Enterprise Ltd. He is also owning 100% share capital of Alpha Ltd. thereby exercising control over it. Hence, Alpha Ltd. is a related party as per para 3 of AS 18.

Disclosure to be made:

Name of the related party	Alpha Ltd.
Nature of relationship	common director
Nature of the transaction	Sale of goods at normal commercial terms
Volume of the transaction	Sales to Alpha Ltd. worth ₹ 2500 thousands

Working Notes:

1. **Tax computation**

	(₹ in '000)
Profit before tax for the year ended 31.3.2017	4,200
Add: Depreciation provided in the books (₹ 300 + ₹ 300 + ₹ 300)	900
	5,100
Less: Depreciation as per Income Tax Act (₹ 480 + ₹ 480 + ₹ 600)	(1,560)
Taxable Income	3,540
Tax at 35% on ₹ 3,540	1,239

2. Calculation of grossing up of dividend

	Rs. in '000s
Dividend	800
Add: Increase for the purpose of grossing up of dividend [{15/(100-15)} x 800]	<u>141.18</u>
	<u>941.18</u>
Dividend distribution tax @ 17.304% 941 x 17.304% = 162.86 i.e.	163 (approx.)

Question 6

After the havoc caused by flood in Jammu and Kashmir, a group of companies undertakes during the period from October, 2016 to December, 2016 various commercial activities, with considerable concessions/discounts, along the related affected areas. The management intends to highlight the expenditure incurred on such activities as expenditure incurred on activities undertaken to discharge corporate social responsibility, while publishing its financial statements for the year 2016-2017. State whether the management's intention is correct or not and why?

Answer

Corporate Social Responsibility (CSR) Reporting is an information communiqué with respect to discharge of social responsibilities of corporate entity. Through 'CSR Report' the corporate enterprises disclose the manner in which they are discharging their social responsibilities. More specifically, it is addressed to the public or society at large, although it can be squarely used by other user groups also.

Section 135 of the Companies Act, 2013 mandated the companies fulfilling the criteria mentioned in the said section to spend certain amount of their profit on activities as specified in the Schedule VII to the Act. Companies not falling within that criteria can also spend on CSR activities voluntarily. However, besides the requirements of constitution of a CSR committee and a CSR policy, the corporate entities should also take care that expenditure incurred for CSR should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

Here, it is assumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the companies. Therefore, the intention of the management to highlight the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

Question 7

Due to immense loss to Nepal in the recent earthquake, one FMCG Company undertakes various commercial activities with considerable discounts and concessions at the related *affected areas of Nepal for a continuous period of 3 months after earthquake. In the Financial Statements for the year 2014-15, the Management has shown the expenditure incurred on such activity as expenditure incurred to discharge Corporate Social Responsibility. State whether the treatment done by the management of management is correct. Explain with reasons.*

Answer

The Companies Act, 2013 mandated the corporate entities that the expenditure incurred for Corporate Social Responsibility (CSR) should not be the expenditure incurred for the activities in the ordinary course of business. If expenditure incurred is for the activities in the ordinary course of business, then it will not be qualified as expenditure incurred on CSR activities.

The statutory guidelines relating to CSR also require the deployment of funds for the benefit of the local area of the Company. Since Nepal is another country the expenditure done there i.e. in Nepal shall not qualify to be accounted as CSR expenditure.

Further, it is presumed that the commercial activities performed at concessional rates are the activities done in the ordinary course of business of the company. Therefore, the treatment done by the Management by showing the expenditure incurred on such commercial activities in its financial statements as the expenditure incurred on activities undertaken to discharge CSR, is not correct.

Exercise

Question 1

What disclosures are required by the listed companies as per SEBI Guidelines?

Question 2

Marks Limited manufactures a special type of Computer. The company has a software division for developing programs with respect to specialized areas such as Medical Imaging, Process Control and Information System.

Following is the draft Profit and Loss Account prepared by the Chief Accountant for the year ended 31st March, 2017:

	Figures in lakhs	
	₹	₹
Sales: Hardware division	*1,200*	
Software division	*800*	*2,000*
Less: Opening inventory of finished goods	*90*	
Raw materials consumed	*400*	
Direct labour — Hardware division	*250*	
— Software division	*150*	
Variable production overheads — Hardware division	*150*	

— Software division	50	
Fixed Production Overheads [including interest and depreciation]		
— Hardware division	290	
— Software division	100	(1,480)
		520
Add: Closing inventory of finished goods		180
Gross Profit		700
Less: Administration Expenses	50	
Selling and distribution expenses	150	(200)
Profit before tax		500
Less: Tax at 40%		(200)
Profit after tax		300
Add: Balance of profit b/f		200
Profit carried forward		500

The following further information are given:

(a) *10 employees, who were working in a software division were made redundant on account of abandoning a particular software program and each of them were paid a compensation of ₹ 5 lakhs on the average. This cost is included in direct labour.*

(b) *The fixed production overheads of Hardware division included interest of ₹ 50 lakhs and depreciation of ₹ 50 lakhs. Further this sum of ₹ 50 lakhs included an additional depreciation of ₹ 10 lakhs on a special machinery used in the manufacturer of computer parts for better display purposes.*

(c) *During the year, the Software division supplied a special program for a foreign firm on a consideration of ₹ 100 lakhs. It was found on June 1st 2017 that the foreign firm has become bankrupt. The company had received an advance of ₹ 50 lakhs in the year ended 31st March, 2017 from the foreign firm.*

(d) *The Software division was involved in a special program on hospital information system. The company so far incurred a sum of ₹ 20 lakhs as salaries and ₹ 10 lakhs as overheads, which were included in direct labour and fixed production overheads respectively. Management feels that a further ₹ 50 lakhs will be required to complete the program, so that it can be effectively marketed.*

(e) *Included in Fixed production overheads of Hardware division is a sum of ₹ 50 lakhs being the cost of prototype computers manufactured by the company. These are not to be sold, but to be kept back for demonstrating the medical imaging software program.*

(f) *The company manufactured 550 computers during the year. It has a policy of valuing finished inventory of goods at a standard cost of ₹ 1.8 lakhs per computer.*

You are required to:

(i) Redraft the Profit and Loss Account for the year ended 31st March, 2017 with reference to relevant Accounting Standards issued by the institute.

(ii) Compute the value of Closing Inventory of finished goods.

[Answer: Profit after tax ₹ 312 lakhs; Surplus carried to balance sheet ₹ 512 lakhs; for the purpose of tax computation, ₹ 520 lakhs have been taken as taxable profits.

As per AS 2 (Revised) on Valuation of Inventories, finished inventory of goods should be valued on the basis of absorption costing. In this case finished inventory has been valued at a standard cost of ₹ 1.8 lakhs per computer which incidentally synchronizes with the value computed on the basis of absorption costing (Cost per computer 990/550 = ₹ 1.8 lakhs.)]

4

Accounting for Corporate Restructuring

BASIC CONCEPTS

Corporate restructuring (CR) is a broad term to denote significant reorientation or realignment of the investment (assets) and/or financing (liabilities) structure of a company through conscious management action with a view to drastically alter the quality and quantum of its future cash flow streams. This broad definition includes such corporate actions as mergers, acquisitions/ amalgamations/ absorption, divestitures, demergers (spin-offs) and debt-equity changes.

The different methods of restructuring and their implications are discussed below:

(1) External Restructuring
  - (a) Asset-based (portfolio) restructuring
  - (b) Financial or capital restructuring

(2) Internal Restructuring
  - (a) Portfolio restructuring (Cost reduction through closure of units, redundancy programmes etc.)
  - (b) Organisational restructuring (Management or organisational restructuring involving decentralisation, delayering, product-market based divisionalisation, matrix structure etc.)

(3) Amalgamation, absorption or external reconstruction.

Asset-based Restructuring

(i) **Mergers and Acquisitions (M & A)**

In the Indian context the term merger is used to denote consolidation of separate legal entities, not necessarily of similar sizes, into one through a statutory process of amalgamation. The motives of merger or acquisition are the same and both involve transfer of ownership and control of assets and the right to manage corporate cash flows.

For Example-Reliance Natural and Reliance Power Merger

(ii) **Divestitures and Asset Swaps**

Divestiture refers to disposal (in favour of third party) of business units, subsidiary companies or significant holdings in associates, often for cash. Asset swap, on other hand, entails simultaneous divesting and acquisition of each other's business by two companies, settling the difference in valuation, if any in cash.

(iii) **Demergers or Spin-offs**

Demerger involves spinning off (profitable or robust) parts of a diversified company into a new company and undertaking free distribution of the shares of the new (spun-off) company to the shareholders of the original company. For Example-RIL gets split among several companies between two brothers-Mukesh and Anil Ambani.

Unlike in a divestiture, the "parent" company or group does not receive any proceeds from a demerger as the demerged company's shares are directly distributed to the "parent" company's shareholders.

Capital and Financial Restructuring

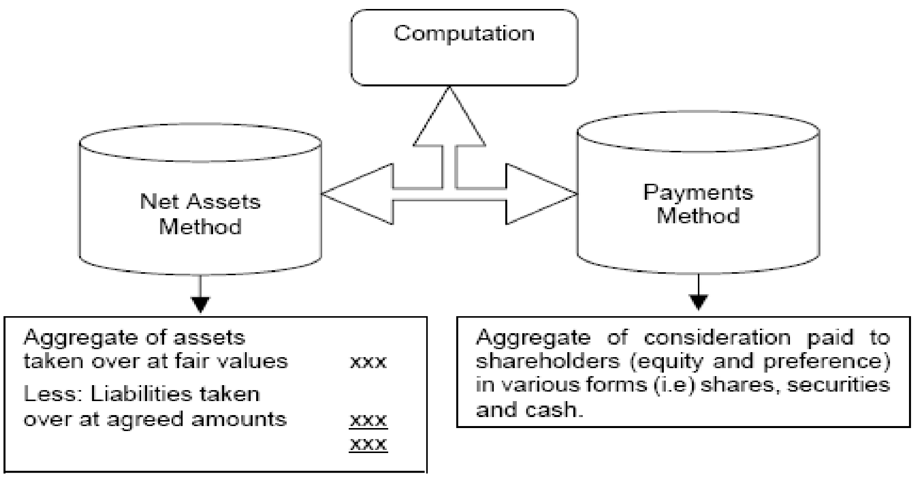
This type of restructuring includes buy back of shares, debt to equity conversions etc.

Purchase Consideration (PC)

In the problem information for PC will be available in two ways. Firstly, list of the various consideration paid is given, one should take care to add only those items paid to the members of the company and not to any outsider.

Secondly, assets and liabilities taken over are given in the problem. Purchase consideration in this case will be the net assets taken over by the amalgamated company.

Computation of Purchase consideration



Discharge of Purchase Consideration

The purchase consideration in the case of amalgamation is payable to the shareholders, both preference and equity, of the transferor company. This may be discharged by issuing preference and/or equity shares of the transferee company and partly by cash. Often the transferee company discharges claims of the preference shareholders of the transferor company at a premium or at a discount by issuing preference shares. Similarly, claims of the equity shareholders of the transferor company may also be discharged by issuing equity shares of the transferee company either at par or at premium or at discount. Debentures paid to shareholders of the transferor company will be considered as part of purchase consideration but debentures paid to the debenture holders or to the trade payables of the transferor company will not form part of purchase consideration.

Methods of Accounting for Amalgamation

There are two main methods of accounting for amalgamations:

(a) The Pooling of Interest Method (for amalgamation in the nature of merger), and

(b) The Purchase Method (for amalgamation in the nature of purchase).

The first method is applied in case of amalgamation in the nature of merger and the second method in case of amalgamation in the nature of purchase.

- **The Pooling of Interest Method:** Under this method the assets, liabilities and all reserves of the transferor company are recorded by transferee company at their existing carrying amounts unless the carrying amounts are to be adjusted to follow a uniform set of accounting policies. The balance of the profit and loss account of the transferor company should be aggregated with the corresponding balance of the transferee company or transferred to general reserve, if any.

  The difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of transferor company should be adjusted in reserves.

  Therefore, no 'goodwill' arises in case of amalgamations in the nature of merger.

- **The Purchase Method:** Here the assets and liabilities of the transferor company should be incorporated in the transferee company's financial statements in either of the following two ways:

  (i) at their existing carrying amounts; or

  (ii) the purchase consideration should be allocated to individual identifiable assets and liabilities on the basis of their fair values at the date of amalgamation.

The important differences between the two methods of accounting are summarised below:

Particulars	Pooling of Interest	Purchase
Discharge of purchase consideration	Mainly shares; cash for settling dues of fractional shares	Shares, or other securities, or cash
Assets and Liabilities	Recorded at book values	Recorded at Fair values
Reserves	Are brought into and recorded in the books	Only statutory reserves are recorded by debit to Amalgamation adjustment account (reversed when statutory conditions are met)
Difference between consideration and net value of assets	Not recorded – difference is adjusted against reserves	Recorded as goodwill or capital reserve

Treatment of Difference of Purchase Consideration and Asset and Liabilities Taken over

<u>If it is in the nature of purchase</u>

Consideration > Net Asset value = GOODWILL

(It is considered appropriate to amortize goodwill over a period not exceeding five years unless a somewhat longer period can be justified.)

Consideration < Net Asset value = CAPITAL RESERVE

<u>If it is in the nature of merger</u>

Consideration > Net Asset value = CAPITAL RESERVE

Consideration < Net Asset value = CAPITAL RESERVE

Treatment of Statutory Reserves-In case of Purchase

The reserves of the transferor company, other than statutory reserves, should not be included in the financial statements of the transferee company. In case of statutory reserves (i.e., Development Allowance Reserve, Investment Allowance Reserve etc.) where the maintenance of such reserves for a specific period is required by statute, these should be recorded in the financial statements of the transferee company with the help of the following entry:

Amalgamation Adjustment A/c Dr.

To Statutory Reserves A/c

Demerger

Question 1

The summarized Balance Sheet of Z Ltd. as at 31st March, 2016 is given below. In it, the respective shares of the company's two divisions namely S Division and W Division in the various assets and liabilities have also been shown.

(₹ in crores)

	S Division	W Division	Total
Fixed Assets:			
Cost	875	249	
Less: Depreciation	(360)	(81)	
Written-down value	515	168	683
Investments			97
Net Current assets:			
Current Assets	445	585	
Less: Current Liabilities	(270)	(93)	
	175	492	667
			1,447
Financed by:			
Loan funds		15	417
Own funds:			
Equity share capital: shares of ₹ 10 each			345
Reserves and surplus			685
			1,447

Loan funds included, inter alia, Bank Loans of ₹ 15 crores specifically taken for W Division and Debentures of the paid up value of ₹ 125 crores redeemable at any time between 1st October, 2015 and 30th September, 2016.

On 1st April, 2016 the company sold all of its investments for ₹ 102 crores and redeemed all the debentures at par, the cash transactions being recorded in the Bank Account pertaining to S Division.

Then a new company named Y Ltd. was incorporated with an authorized capital of ₹ 900 crores divided into shares of ₹ 10 each. All the assets and liabilities pertaining to W Division were transferred to the newly formed company; Y Ltd. allotting to Z Ltd.'s shareholders its two fully paid equity shares of ₹ 10 each at par for every fully paid equity share of ₹ 10 each held in Z Ltd. as discharge of consideration for the division taken over.

Y Ltd. recorded in its books the fixed assets at ₹ 218 crores and all other assets and liabilities at the same values at which they appeared in the books of Z Ltd.

You are required to:

(i) Show the journal entries in the books of Z Ltd.

(ii) Prepare Z Ltd.'s Balance Sheet immediately after the demerger and the initial Balance Sheet of Y Ltd.

(iii) Calculate the intrinsic value of one share of Z Ltd. immediately before the demerger and immediately after the demerger; and

(iv) Calculate the gain, if any, per share to the shareholders of Z Ltd. arising out of the demerger.

Answer

(i) **Journal Entries in Z Ltd.'s books** *(₹ in crores)*

		Dr. Amount	*Cr. Amount*
Bank Account (Current Assets)	Dr.	102	
To Investments			97
To Profit and Loss Account (Reserves and Surplus)			5
(Sale of investments at a profit of ₹ 5 crores)			
Debentures (Loan Funds)	Dr.	125	
To Bank Account (Current Assets)			125
(Redemption of debentures at par)			
Current Liabilities	Dr.	93	
Bank Loan (Loan Funds)	Dr.	15	
Provision for Depreciation	Dr.	81	
Reserves and Surplus (Loss on Demerger)	Dr.	645	
To Fixed Assets			249
To Current Assets			585
(Assets and liabilities pertaining to W Division taken out of the books on transfer of the division to Y Ltd.)			

(ii) (a) **Z Ltd.'s Balance Sheet after demerger**

Particulars	*Note No.*	*(₹ in crores)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		345
(b) Reserve and Surplus	1	45

	(2) **Non-Current Liabilities**		
	Long-term borrowings	2	277
	(3) **Current Liabilities**		270
	Total		937
II.	Assets		
	(1) **Non-current assets**		
	Fixed assets		
	Tangible assets		515
	(2) **Current assets**	3	422
	Total		937

Notes to Accounts:

			(₹ in crores)
1.	Reserves and Surplus		
	Balance as on 31st March, 2016		685
	Add: Profit on sale of investments		5
			690
	Less: Loss on demerger		(645)
	Balance shown in balance sheet after demerger (gain)		45
2.	Loan Funds		
	Balance as on 31st March, 2016		417
	Less: Bank Loan transferred to Y Ltd.	15	
	Debentures redeemed	125	(140)
	Balance shown in balance sheet after demerger		277
3.	Current Assets		
	Balance as on 31st March, 2016		445
	Add: Cash received from sale of investments		102
			547
	Less: Cash paid to redeem debentures		(125)
	Balance in balance sheet after demerger		422

(b) Initial Balance Sheet of Y Ltd.

Particulars	*Note No.*	*(₹ in crores)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	690
(b) Reserves and Surplus	2	5
(2) **Non-Current Liabilities**		
Long-term borrowings	3	15
(3) **Current Liabilities**		93
Total		803
II. **Assets**		
(1) **Non-current assets**		
Fixed assets (Revalued)		218
(2) **Current assets**		585
Total		803

Notes to Accounts:

1. Share Capital

	(₹ in crores)
Authorised capital	
90 crores Equity shares of ₹ 10 each	900
Issued and subscribed capital	
69 crores Equity shares of ₹ 10 each	690
(issued for consideration other than cash)	

2. Reserves and Surplus

		(₹ in crores)
Capital Reserve		
Purchase consideration		690
Less: Assets transferred*	710	
Loan funds transferred	(15)	(695)
Capital reserve		5

* The fixed assets have been recorded at 218 crores instead of 168 crores as in the books of Z Ltd before demerger. Therefore, Y Ltd. makes a capital profit of 5 crores whereas Z Ltd is having a capital gain of 45 crores.

3. Long-term borrowing

Loan Funds	15

(iii) Calculation of intrinsic value of one share of Z Ltd.

Particulars	*Before demerger (Division S and W)*	*After demerger (Division S)*
Fixed Assets	683	515
Net Current Assets	(667-125+102) 644	(175-125+102) 152
Total Assets	1,327	667
Less: Loan Funds	(292)	(277)
	(417-125)	(417-125-15)
Net Asset Value	1,035	390
No. of share	34.5	34.5
Intrinsic Value per share	₹ 30/Share	₹ 11.30/Share

Intrinsic Value of one share = ₹ $\frac{390 \text{ crores}}{34.5 \text{ crores}}$ = ₹ 11.30 per share

(iv) Gain per share to Shareholders:

After demerger, for every share in Z Ltd. the shareholder holds 2 shares in Y Ltd.

	₹
Value of one share in Z Ltd.	11.30
Value of two shares in Y Ltd.	
Value per share = (Net Assets / No. of shares i.e.695/69 = ₹ 10.07× 2)	20.14
	31.44
Less: Value of one share before demerger	(30.00)
Gain per share	1.44

The gain per share amounting ₹ 1.44 is due to appreciation in the value of fixed assets by Y Ltd.

Question 2

Ksha Ltd. and Yaa Ltd. are two companies. On 31st March, 2016 their summarised Balance Sheets were as under:

(₹ in crores)

	Ksha Ltd.		Yaa Ltd.	
	₹	₹	₹	₹
Sources of funds:				
Share Capital:				
Authorised:		500		500
Issued: Equity shares of ₹ 10 each fully paid up		300		200
Reserves and surplus:				
Capital reserves	40		20	
Revenue reserves	700		425	
Surplus	10	750	5	450
Owners' funds		1,050		650
Loan funds		250		350
		1,300		1,000
Fund employed in:				
Fixed assets:				
Cost	1,000		700	
Less: Depreciation	(400)	600	(300)	400
Net current assets:				
Current assets	2,000		1,500	
Less: Current liabilities	(1,300)	700	(900)	600
		1,300		1,000

Ksha Ltd. has 2 divisions, very profitable division A and loss making division B. Yaa Ltd. similarly has 2 divisions, very profitable division C and loss making division D.

The two companies decided to reorganize. Necessary approvals from trade payables and members and sanction by High Court have been obtained to the following scheme:

1. *Division B of Ksha Ltd. which has fixed assets costing ₹ 400 crores (written down value ₹ 160 crores), Current assets ₹ 900 crores, Current liabilities ₹ 750 crores and loan funds of ₹ 200 crores is to be transferred at ₹ 125 crores to Yaa Ltd.*
2. *Division D of Yaa Ltd. which has fixed assets costing ₹ 500 crores (depreciation ₹ 200 crores), Current assets ₹ 800 crores, Current liabilities ₹ 700 crores, and loan funds ₹ 250 crores is to be transferred at ₹ 140 crores to Ksha Ltd.*
3. *The difference in the two considerations is to be treated as loan carrying interest at 15% per annum.*

4. *The directors of each of the companies revalued the fixed assets taken over as* follows:
   (i) *Division of D of Yaa Ltd. taken over: ₹ 325 crores.*
   (ii) *Division B of Ksha Ltd. taken over: ₹ 200 crores.*

All the other assets and liabilities are recorded at the balance sheet values.

(a) *The directors of both the companies ask you to prepare the balance sheets after reconstruction (showing the corresponding figures before reconstruction).*

(b) *Master Richie Rich, who owns 50,000 equity shares of Ksha Ltd. and 30,000 equity shares of Yaa Ltd. wants to know whether he has gained or lost in terms of net asset value of equity shares on the above reorganizations.*

Answer

(a)

Ksha Ltd.
Balance Sheet as at 31st March, 2016

Particulars	*Note No.*	*After reconstruction*	*Before reconstruction*
		(₹ in crores)	*(₹ in crores)*
I. Equity and Liabilities			
(1) **Shareholder's Funds**			
(a) Share Capital	1	300	300
(b) Reserve and Surplus	2	800	750
(2) **Non-Current Liabilities**			
Long-term borrowings	3	315	250
(3) **Current Liabilities**		1,250	1,300
Total		2,665	2,600
II. Assets			
(1) **Non-current assets**			
(a) Fixed assets			
Tangible assets	4	765	600
(2) **Current assets**		1,900	2,000
Total		2,665	2,600

Notes to Accounts

	Particulars	After reconstruction (₹ in Crores)		Before reconstruction (₹ in Crores)	
1.	**Share Capital**				
	Authorised:				
	50 crores equity shares of ₹10 each Issued and subscribed:		500		500
	30 crores equity shares of ₹10 each fully paid up		300		300
2.	**Reserves and surplus**				
	Capital reserves	40		40	
	Add: Capital profit on reconstruction [WN 1(ii & iii)]	50		-	
	Revenue reserves	700		700	
	Surplus	10	800	10	750
3.	**Long term Borrowings**				
	Yaa Ltd. (Interest @ 15% p.a.) [WN 1(i)]	15			
	Others	300	315		250
4.	**Fixed assets**				
	Gross block	925		1,000	
	Less: Depreciation	(160)		(400)	
	Net block		765		600

Yaa Ltd.
Balance Sheet as at 31st March, 2016

Particulars	Note No.	After reconstruction (₹ in Crores)	Before reconstruction (₹ in Crores)
I. **Equity and Liabilities**			
(1) **Shareholder's Funds**			
(a) Share Capital	1	200	200
(b) Reserves and Surplus	2	465	450

(2) **Non-Current Liabilities**			
Long-term borrowings		300	350
(3) **Current Liabilities**		950	900
Total		1,915	1,900
II. **Assets**			
(1) **Non-current assets**			
Fixed assets			
Tangible assets	3	300	400
Long term loans and advances	4	15	-
(2) **Current assets**			
Other current assets		1,600	1,500
Total		1,915	1,900

Notes to Accounts

	Particulars	*After reconstruction*		*Before reconstruction*	
		(₹ in crores)		*(₹ in crores)*	
1.	**Share Capital**				
	Authorized:				
	50 crores equity shares of ₹ 10 each		500		500
	Issued and subscribed:				
	20 crores equity shares of ₹ 10 each fully paid up		200		200
2.	**Reserves and surplus**				
	Capital reserves	20		20	
	Add: Capital profit on reconstruction [WN 1(ii)]	15	35	-	20
	Revenue reserves		425		425
	Surplus		5		5
			465		450
3.	**Tangible assets:**				
	Gross block	400		700	
	Less: Depreciation	(100)		(300)	
	Net block		300		400

4.	**Long-term loans and advances**				
	Loan to Ksha Ltd.[WN 2(i)]		15		----

(b) Net asset value of Master Riche Rich's holdings

	Pre-reorganisation (₹)	*Post-reorganisation (₹)*	*Change (Gain) (₹)*
Net asset value of one equity share:			
(Refer to working notes)			
Ksha Ltd.	35.00	36.67	1.67
Yaa Ltd.	32.50	33.25	0.75
Net asset value of equity shares owned by Master Riche Rich			
Ksha Ltd. (50,000 shares)	17,50,000	18,33,500	83,500
Yaa Ltd. (30,000 shares)	9,75,000	9,97,500	22,500
	27,25,000	28,31,000	1,06,000

Master Riche Rich has gained in terms of net asset value of his holdings as indicated in the last column.

Working Notes:

(1) Ksha Ltd. (₹ in crores)

		Pre-re-organisation figures (a)	*Sale of division B (b)*	*Purchase of division D of Yaa Ltd. (c)*	*Post-re-organisation figures (d) = (a) – (b) + (c)*
(i)	Fixed assets:				
	Cost	1,000	400	325	925
	Depreciation	(400)	(240)	-	(160)
	Written down value (I)	600	160	325	765
	Current assets	2,000	900	800	1,900
	Current liabilities	(1,300)	(750)	(700)	(1,250)

	Net current assets (II)	700	150	100	650
	Funds employed [(I) + (II)]	1,300	310	425	1,415
	Loan funds:				
	Others (III)	(250)	(200)	(250)	(300)
	Yaa Ltd. (balance payable on transfers of divisions i.e. ₹ 140 – ₹ 125) (IV)				(15)
	Net worth (I + II – III – IV)	1,050	110	175	1,100

Calculation of Profit/(Loss) on Division sale and purchase

(ii)	Sale of division B		*(₹ in crores)*
	Transfer price		125
	Cost of the division (₹ 160 + ₹ 150 – ₹ 200)		(110)
	Capital Profit		15
(iii)	Purchase of division D of Yaa Ltd.		
	Agreed value of assets less liabilities taken over ₹ (325 + 800-700 – 250)		175
	Less: Transfer price		(140)
	Capital Profit		35
(iv)	Pre-reorganisation net worth		1,050
	Add: Capital profit on		
	Sale	15	
	Acquisition	35	50
	Post-reorganisation net worth		1,100

No. of equity shares	30 crores
Net asset value of equity share:	₹
Pre-reorganisation	1,050/30 = 35.00
Post-reorganisation	1,100/30 = 36.67 (rounded off)

(2) Yaa Ltd.

(i) (₹ in crores)

	Pre-re-organisation figures (a)	*Sale of division D* (b)	*Purchase of division B of Ksha Ltd.* (c)	*Post-re-organisation figures* (d) = (a) – (b) + (c)
Fixed assets:				
Cost	700	500	200	400
Depreciation	(300)	(200)	–	(100)
Written down value (I)	400	300	200	300
Current assets	1,500	800	900	1,600
Current liabilities	(900)	(700)	(750)	(950)
Net current assets (II)	600	100	150	650
Funds employed [(I) + (II)]	1,000	400	350	950
Loan funds–others (III)	(350)	(250)	(200)	(300)
	650	150	150	650
Ksha Ltd. (balance on account of transfers of divisions) (IV)	-	-	-	15
Net worth (I + II – III + IV)	650	150	150	665

(ii) *(₹ in crores)*

	Purchase of division B of Ksha Ltd.		*Sale of division D*
Value of assets less liabilities			
(Value to Yaa Ltd.) (200 + 900 – 750 – 200)	150	(300 + 800 – 700 – 250)	150
Less: Transfer Price	(125)		(140)
Capital Profit/(Capital Loss)	25		(10)

(iii) (₹ in crores)

Pre-reorganisation net worth		650
Add: Capital profit - on acquisition	25	
- Sale	(10)	15
Post-reorganisation net worth		665

No. of equity shares	20 crores
Net asset value of equity share:	₹
Pre-reorganisation	650/20 = 32.50
Post-reorganisation	665/20 = 33.25

Buy Back of Shares

Question 3

The summarized Balance Sheet of Gunshot Ltd. (a unlisted company) as on 31.3.2016 is given:

(₹ in '000)

Liabilities	*Amount*	*Assets*	*Amount*
Share Capital :		*Fixed Assets*	*2,700*
Equity shares of ₹ 10 each	*800*	*Non-trade Investments*	*300*
Securities Premium	*100*	*Inventory*	*600*
General Reserve	*780*	*Trade receivables*	*360*
Profit and Loss Account	*120*	*Cash and Bank*	*160*
10% Debenture	*2,000*		
Trade payables	*320*		
	4,120		*4,120*

Gunshot Ltd. buy back 16,000 shares of ₹ 20 per share. For this purpose, the Company sold its all non-trade investments for ₹ 3,20,000. Give Journal Entries with full narrations affecting the buy back.

Answer

In the books of Gunshot Ltd.

Journal Entries for Buy-back of shares

			₹	₹
(i)	Bank A/c	Dr.	3,20,000	
	To Non-trade Investments			3,00,000
	To Profit & Loss A/c			20,000
	(Being the entry for sale of Non-trade Investments)			
(ii)	Shares Buy back A/c (16,000 x ₹ 20)	Dr.	3,20,000	
	To Bank A/c			3,20,000
	(Being purchase of 16,000 shares @ ₹ 20 per share)			

(iii)	Equity Share Capital A/c (16,000 x ₹ 10)	Dr.	1,60,000	
	Buy-back Premium (16,000 x ₹ 10)	Dr.	1,60,000	
	To Shares Buy-back A/c			3,20,000
	(Being cancellation of shares bought back)			
(iv)	Securities Premium A/c	Dr.	1,00,000	
	General Reserve	Dr.	60,000	
	To Buy-back Premium			1,60,000
	(Being adjustment of buy-back premium)			
(v)	General Reserve	Dr.	1,60,000	
	To Capital Redemption Reserve			1,60,000
	(Being the entry for transfer of General Reserve to Capital Redemption Reserve to the extent of face value of equity shares bought back)			

Question 4

Kharid Ltd. has the following capital structure as on 31-03-2016:

Particulars		*(₹ in crores)*
Equity share capital (shares of ₹ 10 each, fully paid)		*660*
Reserve and Surplus:		
General Reserve	*480*	
Securities Premium Account	*180*	
Profit and Loss Account	*180*	
Infrastructure Development Reserve	*360*	*1200*
Loan Funds		*3,600*

The shareholders of Kharid Ltd. have on the recommendation of their Board of Directors approved on 12-09-2016, a proposal to buy-back 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 20% over market value.

You are also informed that the Infrastructure Development Reserve is created to satisfy income tax 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 ₹ 2,400 crores or ₹ 3,000 crores.

Assuming that the entire buy-back is completed by 09-12-2016, show-the accounting entries with full narrations in the company's books in each situation.

Answer

(a) Statement determining the maximum number of shares to be bought back

Number of shares

Particulars	*When loan fund is*		
	₹ 3,600 crores	*₹ 2,400 crores*	*₹ 3,000 crores*
Shares Outstanding Test (W.N.1)*	16.5	16.5	16.5
Resources Test (W.N.2)	12.5	12.5	12.5
Debt Equity Ratio Test (W.N.3)	Nil	7.5	Nil
Maximum number of shares that can be bought back [least of the above]	Nil	7.5	Nil

(b) Journal Entries for the Buy Back (applicable only when loan fund is ₹ 2,400 crores)

			₹ in crores	
			Debit	*Credit*
(a)	Equity share buy back account	Dr.	225	
	To Bank account			225
	(Being buy back of 7.5 crores equity shares of ₹ 10 each @ ₹ 30 per share)			
(b)	Equity share capital account	Dr.	75	
	Securities premium account	Dr.	150	
	To Equity share buy back account			225
	(Being cancellation of shares bought back)			
(c)	General reserve account	Dr.	75	
	To Capital redemption reserve account			75
	(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)			

*The entry has been made according to the information given in the question. It may be noted that according to Securities and Exchange Board of India (Buy-back of Securities Amendment) Regulations, 2013, 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.

Working Notes:

1. Shares Outstanding Test

Particulars	*(Shares in crores)*
Number of shares outstanding	66
25% of the shares outstanding	16.5

2. Resources Test

Particulars		
Paid up capital (₹ in crores)		660
Free reserves (₹ in crores)		
General Reserve	480	
Securities Premium A/c	180	
Profit and Loss A/c	180	840
Shareholders' funds (₹ in crores)		1,500
25% of Shareholders fund (₹ in crores)		375
Buy-back price per share (₹) (₹ 25 x 120%)		₹ 30
Number of shares that can be bought back (shares in crores)		12.5 crores shares

3. Debt Equity Ratio Test

	Particulars	*When loan fund is*		
		₹ 3,600 crores	*₹ 2,400 crores*	*₹ 3,000 crores*
(a)	Loan funds (₹ in crores)	3,600	2,400	3,000
(b)	Minimum equity to be maintained after buy back in the ratio of 2:1(₹ in crores)	1,800	1,200	1,500
(c)	Present equity (₹ in crores) (W.N.2)	1,500	1,500	1,500
(d)	Future equity (₹ in crores) (See Note 2)	N.A.	1,425 (1,500-75)	N.A.
(e)	Maximum permitted buy back of Equity (₹ in crores) [(d) – (b)] (See Note 2)	Nil	225 (by simultaneous equation)	Nil
(f)	Maximum number of shares that can be bought back @ ₹ 30 per share (shares in crores) (See Note 2)	Nil	7.5 (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 Section 68 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. Also as per the section, on buy-back of shares, out of free reserves a sum equal to the nominal value of the share bought back shall be transferred to Capital Redemption Reserve (CRR). As per section 55 of the Companies Act, 2013**, 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 buy-back has to be deducted from present equity.

   Amount transferred to CRR and maximum equity to be bought back will be calculated by simultaneous equation method.

   Suppose amount transferred to CRR account is 'x' and maximum permitted buy-back of equity is 'y'.

   Then, $(1{,}500 - x) - 1200 = y$ (1)

   $\frac{y}{30} \times 10 = x$ Or, $3x = y$ (2)

   by solving the above equation, we get

   x = ₹ 75 crores

   y = ₹ 225 crores

Amalgamation / Absorption

Question 5

A Ltd. and B Ltd. were amalgamated on and from 1st April, 2016. A new company C Ltd. was formed to take over the business of the existing companies. The summarized Balance Sheets of A Ltd. and B Ltd. as on 31st March, 2016 are given below:

	(₹ in lakhs)			(₹ in lakhs)	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Share Capital			*Fixed Assets*		

* Erstwhile Section 77A of the Companies Act, 1956.

** Erstwhile Section 80 of the Companies Act, 1956.

Equity Shares of ₹ 100 each	*800*	*750*	*Land and Building*	*550*	*400*
12% Preference shares of ₹ 100 each	*300*	*200*	*Plant and Machinery*	*350*	*250*
Reserves and Surplus			*Investments*	*150*	*50*
Revaluation Reserve	*150*	*100*	*Current Assets, Loans and Advances*		
General Reserve	*170*	*150*			
Investment Allowance Reserve	*50*	*50*	*Inventory*	*350*	*250*
Profit and Loss Account	*50*	*30*	*Trade receivables*	*300*	*350*
Secured Loans			*Cash and Bank*	*300*	*200*
10% Debentures (₹ 100 each)	*60*	*30*			
Current Liabilities and Provisions					
Trade payables	*420*	*190*			
	2,000	*1,500*		*2,000*	*1,500*

Additional Information:

(1) 10% Debenture holders of A Ltd. and B Ltd. are discharged by C Ltd. issuing such number of its 15% Debentures of ₹ 100 each so as to maintain the same amount of interest.

(2) Preference shareholders of the two companies are issued equivalent number of 15% preference shares of C Ltd. at a price of ₹ 150 per share (face value of ₹ 100).

(3) C Ltd. will issue 5 equity shares for each equity share of A Ltd. and 4 equity shares for each equity share of B Ltd. The shares are to be issued @ ₹ 30 each, having a face value of ₹ 10 per share.

(4) Investment allowance reserve is to be maintained for 4 more years.

Prepare the Balance Sheet of C Ltd. as on 1st April, 2016 after the amalgamation has been carried out on the basis of Amalgamation in the nature of purchase.

Answer

Balance Sheet of C Ltd.
as at 1st April, 2016

Particulars	*Note No.*	*(₹ in lakhs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	1,200
(b) Reserves and Surplus	2	1,750

	(2) **Non-Current Liabilities**		
	Long-term borrowings	3	60
	(3) **Current Liabilities**		
	Trade payables	9	610
	Total		3,620
II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	i. Tangible assets	4	1,550
	ii. Intangible assets	5	20
	(b) Non-current investments	6	200
	(c) Other non-current assets	7	100
	(2) **Current assets**		
	(a) Inventories		600
	(b) Trade receivables	8	650
	(c) Cash and cash equivalents		500
	Total		3,620

Notes to Accounts

		(₹ in lakhs)	*(₹ in lakhs)*
1.	Share Capital		
	Equity share capital (W.N.2)		
	70,00,000 Equity shares of ₹ 10 each	700	
	5,00,000 Preference shares of ₹ 100 each	500	
	(all the above shares are allotted as fully paid-up pursuant		
	to contracts without payment being received in cash)	____	1,200
2.	Reserves and surplus		
	Securities Premium Account	1,650	
	Investment Allowance Reserve	100	1,750
3.	Long-term borrowings		
	15% Debentures		60
4.	Tangible assets		
	Land and Building	950	

	Plant and Machinery	600	1,550
5.	Intangible assets		
	Goodwill [W.N. 2]		20
6.	Non-current Investments		
	Investments		200
7.	Other non-current assets		
	Amalgamation Adjustment Account		100
8.	Trade receivables		
	A Ltd.	300	
	B Ltd.	350	650
9.	Trade payables		
	A Ltd.	420	
	B Ltd.	190	610

Working Notes:

		(₹ in lakhs)	
		A Ltd.	*B Ltd.*
(1)	Computation of Purchase consideration		
	(a) Preference shareholders:		
	$\left(\frac{3,00,00,000}{100}\right)$ i.e. 3,00,000 shares × ₹ 150 each	450	
	$\left(\frac{2,00,00,000}{100}\right)$ i.e. 2,00,000 shares × ₹ 150 each		300
	(b) Equity shareholders:		
	$\left(\frac{8,00,00,000 \times 5}{100}\right)$ i.e. 40,00,000 shares × ₹ 30 each	1,200	
	$\left(\frac{7,50,00,000 \times 4}{100}\right)$ i.e. 30,00,000 shares × ₹ 30 each		900
	Amount of Purchase Consideration	1,650	1,200
(2)	Net Assets Taken Over		
	Assets taken over:		
	Land and Building	550	400

Plant and Machinery		350		250
Investments		150		50
Inventory		350		250
Trade receivables		300		350
Cash and bank		300		200
		2,000		1,500
Less: Liabilities taken over:				
Debentures	40		20	
Trade payables	420		190	
		(460)		(210)
Net assets taken over		1,540		1,290
Purchase consideration		1,650		1,200
Goodwill		110		-
Capital reserve				90

Question 6

The Abridged Balance Sheet (Draft) of V Ltd. as on 31st March, 2016 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* *Inventory*	*2,57,000* *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 Accounts*	*1,25,000*
	4,98,000		*4,98,000*

The following scheme is passed and sanctioned by the court:

(i) A new company P 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 V 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 stock, 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 and Reconstruction (combined) 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.*

Answer

(a) (i) In the books of V Ltd. (Old company)

Realisation and Reconstruction 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 Inventory	50,000	By Trade payables	1,00,000
To Trade receivables	60,000	By P Ltd. (Purchase consideration)	1,36,000
To Bank	1,000	By Equity shareholders A/c (Bal.fig.)	35,000
To Preference share holders A/c (W.N.3)	6,000		
	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 P Ltd.	80,000		

* Erstwhile Schedule VI to the Companies Act, 1956.

To Realisation and Reconstruction A/c	35,000		
	2,40,000		2,40,000

(b) (i) **In the books of P Ltd. (New company)**

Bank Account

	₹		₹
To Business Purchase	1,000	By Goodwill A/c* (for expenses on absorption)	8,000
To Equity shares 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, 2016**

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

* However, as per para 56 of AS 26, if no asset is acquired from the expenditure incurred, then the same is recognized as an expense when it is incurred.

** It is assumed that fixed assets given in the balance sheet of V Ltd. comprises of tangible fixed assets only.

Notes to Accounts

		₹
1.	Share Capital	
	Authorised share capital	
	30,000 equity shares of ₹ 10 each	3,00,000
	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 P 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 $\left(\frac{1,00,000}{100}\times 16\right)+\left(\frac{1,00,000}{100}\times 10\times 10\right)$	1,16,000
	3,60,000
Less: Inventory ₹ (50,000- 3,000) 47,000	
Trade receivables 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 P Ltd.	56,000	By Preference Share capital	50,000
		By Realisation and Reconstruction A/c (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 V Ltd. $\left(\frac{1,00,000}{100}\times 10 \text{ shares}\right)$	10,000	
Preference shareholders of V Ltd.	5,000	
Arrears of preference dividend $\left(\frac{12,000}{100}\times 5\right)$	600	
Equity shareholders of V Ltd. $\left(\frac{24,000}{3}\right)$	8,000	(24,400)
Number of equity shares issued to public at par for cash		5,600

Intrinsic Value

Question 7

The following are the summarized Balance Sheets of Big Ltd. and Small Ltd. for the year ending on 31st March, 2016: *(₹ in crores)*

	Big Ltd.	Small Ltd.
Equity share capital – in equity shares of ₹ 10 each	50	40
Preference share capital – in 10% preference shares of ₹ 100 each	–	60
Reserves and Surplus	200	150
	250	250
Loans – Secured	100	100
Total funds	350	350
Applied for: Fixed assets at cost less depreciation	150	150
Current assets	200	200
	350	350

The present worth of fixed assets of Big Ltd. is ₹ 200 crores and that of Small Ltd. is ₹ 429 crores. Goodwill of Big Ltd. is ₹ 40 crores and of Small Ltd. is ₹ 75 crores.

Small Ltd. absorbs Big Ltd. by issuing equity shares at par in such a way that intrinsic net worth is maintained.

Goodwill account is not to appear in the books. Fixed assets are to appear at old figures.

(a) Show the Balance Sheet after absorption.

(b) Draft a statement of valuation of shares on intrinsic value basis and prove the accuracy of your workings.

Answer

(a) **Small Ltd.**

Balance Sheet as at 1st April, 2016

Particulars	Note No.	(₹ in crores)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	125
(b) Reserves and Surplus	2	375

	(2)	**Non-Current Liabilities**		
		Long-term borrowings	3	200
		Total		700
II.	**Assets**			
	(1)	**Non-current assets**		
		(a) Fixed assets		
		Tangible assets	4	300
	(2)	**Current assets**	5	400
		Total		700

Notes to Accounts

		(₹ in Crores)	(₹ in Crores)
1.	Share Capital		
	6.5 crores equity shares of ₹ 10 each (of the above shares, 2.5 crores equity shares are allotted as fully paid-up for consideration other than cash)	65	
	60 lakhs 10% Preference shares of ₹ 100 each	60	125
2.	Reserves and surplus		
	As per last Balance Sheet	150	
	Capital Reserve (W.N.)	225	375
3.	Long Term Borrowings		
	Secured Loans:		
	As per last Balance Sheet	100	
	Taken over on absorption of Big Ltd.	100	200
4.	Tangible Assets		
	As per last Balance Sheet	150	
	Taken over on absorption of Big Ltd.	150	300
5.	Current assets		
	As per last Balance Sheet	200	
	Taken over on absorption of Big Ltd.	200	400

(b) Valuation of shares on intrinsic value basis

(i)	Big Ltd.	Small Ltd.
	(₹ in crores)	
Equity share capital	50	40
Reserves and Surplus	200	150
	250	190
Goodwill agreed upon	40	75
Increase in the value of fixed assets		
(Present worth less book value)	(200-150) 50	(429-150) 279
Revalued Net Worth	340	544
(ii)	*Big Ltd.*	*Small Ltd.*
Number of Equity shares	5 crores	4 crores
Intrinsic value per equity share	₹ 68	₹ 136
(iii) Ratio of intrinsic value of shares in the two companies	1 : 2	

Since the shares are to be issued at par, the number of equity shares of ₹ 10 each to be issued to maintain the intrinsic net worth = 5 crores /2 = 2.5 crores

(iv) Statement to prove the accuracy of workings

	Small Ltd.	(₹ in crores)
(1)	Equity share capital (after absorption) [40 + (2.5 x 10)]	65
	Reserves and Surplus (after absorption) [WN]	375
		440
	Add: Unrecorded value of goodwill ₹ (40 + 75) [Since athis considered while calculating the intrinsic value]	115
	Add: Unrecorded incremental value of fixed assets ₹ (50+279) [Since at his considered while calculating the intrinsic value]	329
		884
(2)	Number of equity shares	6.5 crores
(3)	Intrinsic value of an equity share (884/6.5)	₹ 136

Working Note:

Calculation of Capital Reserve on Absorption

	(₹ in crores)
Fixed Assets taken over	150
Net current assets taken over	200
	350
Less: Secured loans taken over	(100)
Net Assets taken over	250
Less: Purchase consideration	(25)
Capital Reserve	225
Add: Current Reserves & Surplus	150
Reserves & Surplus after absorption	375

Question 8

Given below is the summarized Balance Sheet of H Ltd. as on 31.3.2016: (₹ in lakhs)

Equity share capital	*4.00*	*Block assets less depreciation to date*	*6.00*
(in equity shares of ₹ 10 each)		*Inventory and trade receivables*	*5.30*
10% Preference share capital	*3.00*	*Cash and bank*	*0.70*
General reserve	*1.00*		
Profit and loss account	*1.00*		
Trade payables	*3.00*		
	12.00		*12.00*

M Ltd. another existing company holds 25% of equity share capital of H Ltd. purchased at ₹ 10 per share.

It was agreed that M Ltd. should take over the entire undertaking of H Ltd. on 30.9.2016 on which date the position of current assets (except cash and bank balances) and trade payables was as follows:

Inventory and trade receivables	*₹ 4 lakhs*
Trade payables	*₹ 2 lakhs*

Profits earned for half year ended 30.09.2016 by H Ltd. was ₹ 70,500 after charging depreciation of ₹ 32,500 on block assets. H Ltd. declared 10% dividend for 2015-2016 on 30.08.2016 and the same was paid within a week.

Goodwill of H Ltd. was valued at ₹ 80,000 and block assets were valued at 10% over their book value as on 31.3.2016 for purposes of take over. Preference shareholders of H Ltd. will *be allotted 10% preference shares of ₹ 10 each by M Ltd. Equity shareholders of H Ltd. will receive requisite number of equity shares of ₹ 10 each from M Ltd. valued at ₹ 10 per share.*

(a) Compute the purchase consideration.

(b) Explain, how the capital reserve or goodwill, if any, will appear in the Balance Sheet of M Ltd. after absorption.

Assume that Block assets have been taken over at 10% appreciated value after considering depreciation.

Answer

(a) Calculation of Purchase Consideration (for net assets of H Ltd. taken over)

Assets taken over:	₹
Goodwill as agreed	80,000
Block Assets at 10% over their book value as on 31.3.2016	6,60,000*
(agreed value for purposes of takeover 6,00,000 X 110%)	
Inventory and trade receivables as on 30.09.2016	4,00,000
Cash and Bank (See Working Note)	1,33,000
	12,73,000
Less: Liabilities taken over:	
Trade payables as on 30.09.2016	(2,00,000)
Purchase Consideration	10,73,000
Calculation of Shares Allotted:	₹
Net Assets taken over	10,73,000
Less: Allotment of 10% preference shares to preference shareholders of H Ltd.	(3,00,000)
	7,73,000
Less: Belonging to M Ltd. (1/4 ×₹ 7,73,000)	(1,93,250)
Payable to other equity shareholders	5,79,750

Number of equity shares of ₹ 10 each to be issued (valued at ₹ 10 each) = 57,975

Calculation of Capital Reserve:	₹	₹
Net Assets taken over		10,73,000
Less: Preference shares to be allotted	(3,00,000)	

* It is assumed that block assets have been taken over at 10% appreciated value after considering depreciation.

Equity shares to be allotted	(5,79,750)	
Cost of investments	(1,00,000)	(9,79,750)
Capital Reserve		93,250
Alternatively, Capital Reserve may be computed as follows:		
Value of investments in H Ltd.		1,93,250
Less: Cost of investments		(1,00,000)
		93,250

(b) Balance Sheet of M Ltd. as at 30th September, 2016 (Extract)

Particulars	*Note No.*	₹
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
Reserves and Surplus	1	13,250

Notes to accounts

1. *Reserves and Surplus*		₹
Capital Reserve	93,250	
Less: Goodwill	(80,000)	13,250

Working Note:

Ascertainment of Cash and Bank Balances as on 30th September, 2016

Balance Sheet as at 30th September, 2016

Particulars	*Note No.*	₹
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	7,00,000
(b) Reserves and Surplus	2	2,00,500
(2) **Current Liabilities**		
Trade Payables	3	2,00,000
Total		11,00,500

II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	Tangible assets	4	5,67,500
	(2) **Current assets**		
	(a) Inventories &Trade receivables	5	4,00,000
	(b) Cash and cash equivalents *(Bal. fig.)*		1,33,000
	Total		11,00,500

Notes to Accounts

			₹	₹
1.	Share Capital			
	Equity Share Capital		4,00,000	
	10% Preference Share Capital		3,00,000	7,00,000
2.	Reserves and surplus			
	General Reserve			1,00,000
	Profit and Loss Account:			
	Balance brought forward	1,00,000		
	Add: Profit for the first half	70,500	1,70,500	
	Less: Dividend on preference share capital paid	30,000		
	Dividend on equity share capital paid	40,000	(70,000)	1,00,500
				2,00,500
3.	Trade Payables			2,00,000
4.	Tangible Assets			
	Block Assets		6,00,000	
	Less: Depreciation		(32,500)	5,67,500
5.	Inventories & Trade Receivables			4,00,000

Question 9

The summarised Balance Sheets of R Ltd. and P Ltd. for the year ending on 31.3.2016 are as under:

	R Ltd. ₹	*P Ltd.* ₹		*R Ltd.* ₹	*P Ltd.* ₹
Equity share Capital (in shares of ₹ 10 each)	*24,00,000*	*12,00,000*	*Fixed Assets*	*55,00,000*	*27,00,000*
			Current Assets	*25,00,000*	*23,00,000*

8% Preference Share Capital (in shares of ₹ 10 each)	*8,00,000*	*–*			
10% Preference Share Capital (in shares of ₹ 10 each)	*–*	*4,00,000*			
Reserves	*30,00,000*	*24,00,000*			
Current Liabilities	*18,00,000*	*10,00,000*			
	80,00,000	*50,00,000*		*80,00,000*	*50,00,000*

The following information is provided:

			R Ltd. ₹	*P Ltd.* ₹
(1)	*(a)*	*Profit before tax*	*10,64,000*	*4,80,000*
	(b)	*Taxation*	*4,00,000*	*2,00,000*
	(c)	*Preference dividend*	*64,000*	*40,000*
	(d)	*Equity dividend*	*2,88,000*	*1,92,000*

(2) The equity shares of both the companies are quoted in the market. Both the companies are carrying on similar manufacturing operations.

(3) R Ltd. proposes to absorb P Ltd. as on 31.3.2016. The terms of absorption are as under:

(a) Preference shareholders of P Ltd. will receive 8% preference shares of R Ltd. sufficient to increase the income of preference shareholders of P Ltd. by 10%.

(b) The equity shareholders of P Ltd. will receive equity shares of R Ltd. on the following basis:

(i) The equity shares of P Ltd. will be valued by applying to the earnings per share of P Ltd. 75% of price earnings ratio of R Ltd. based on the results of 2015-2016 of both the companies.

(ii) The market price of equity shares of R Ltd. is ₹ 40 per share.

(iii) The number of shares to be issued to the equity shareholders of P Ltd. will be based on the above market value.

(iv) In addition to equity shares, 8% preference shares of R Ltd. will be issued to the equity shareholders of P Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2015-2016.

(4) The assets and liabilities of P Ltd. as on 31.3.2016 are revalued by professional valuer as under:

	Increased by ₹	*Decreased by* ₹
Fixed Assets	*1,00,000*	–
Current Assets	–	*2,00,000*
Current Liabilities	–	*40,000*

(5) For the next two years, no increase in the rate of equity dividend is expected.

You are required to:

(i) Set out in detail the purchase consideration.

(ii) Give the Balance Sheet as on 31.3.2016 after absorption.

Note: Journal entries are not required.

Answer

(i) Computation of Purchase Consideration

		₹
(a)	*Preference Shareholders*	
	Current income of preference shareholders of P Ltd.	40,000
	Add: 10% increase thereof	4,000
		44,000
	Preference shares to be issued	
	$= 44,000 \times \frac{100}{8}$	5,50,000
(b)	*Equity Shareholders*	
	(1) Issue of Equity Shares	
	Profit before tax of R Ltd.	10,64,000
	Less: Tax	(4,00,000)
		6,64,000
	Less: Preference dividend	(64,000)
	Profit available for equity shareholders of R Ltd.	6,00,000

Basic EPS = Earningavailable for Shareholders / Average no. of shares

$$\text{Earnings per share (EPS)} = \frac{6,00,000}{2,40,000} = ₹\ 2.50$$

PE Ratio = Market Price / EPS

$$\text{Price earnings ratio (P/E)} = \frac{40}{2.50} = 16$$

EPS of P Ltd.

	₹
Profit before tax	4,80,000
Less: Tax	(2,00,000)
Profit after tax	2,80,000
Less: Preference dividend	(40,000)
Profit available for equity shareholders	2,40,000

$$\text{EPS} = \frac{2,40,000}{1,20,000} = ₹\ 2$$

Valuation of equity shares of P Ltd.

= 1,20,000 shares × (₹ 2 × 16 × 0.75 i.e. ₹ 24) = ₹ 28,80,000

$$\text{Number of equity shares to be issued} = \frac{28,80,000}{40} = 72,000$$

			₹
(1)	*Equity Share Capital*		7,20,000
	Securities Premium		21,60,000
			28,80,000
(2)	*Issue of Preference Shares to make up loss to equity shareholders*		₹
	Current equity dividend		1,92,000
	Less: Expected equity dividend from R Ltd. i.e. in proportion of the existing dividend policy (₹ 7,20,000 × 2,88,000/24,00,000)		(86,400)
Loss in income			1,05,600
8% Preference Shares to be issued = $\frac{1,05,600}{0.08}$ = ₹ 13,20,000			
Total Purchase Consideration:			₹
Preference shares to be issued		5,50,000	
		13,20,000	18,70,000
Equity shares to be issued (at premium)			28,80,000
			47,50,000

(ii)

R Ltd.
Balance Sheet as at 31st March, 2016
(after absorption)

Particulars	*Note No.*	*Amount (₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	57,90,000
(b) Reserves and Surplus	2	51,60,000
(2) **Current Liabilities**	3	27,60,000
Total		1,37,10,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	4	83,00,000
ii. Intangible assets	5	8,10,000
(2) **Current assets**	6	46,00,000
Total		1,37,10,000

Notes to Accounts

		(₹)	(₹)
1.	Share Capital		
	3,12,000 Equity Shares of ₹ 10 each (of the above shares, 72,000 Equity shares are allotted as fully paid up for consideration other than cash)	31,20,000	
	2,67,000 8% Preference Shares of ₹ 10 each (of the above, 1,87,000 are allotted as fully paid up for consideration other than cash)	26,70,000	57,90,000
2.	Reserves and surplus		
	Reserves (As per last Balance Sheet)	30,00,000	
	Securities Premium	21,60,000	51,60,000
3.	Current Liabilities		
	As per last balance sheet	18,00,000	
	Taken over on absorption of P Ltd. ₹ (10,00,000-40,000)	9,60,000	27,60,000

4.	Tangible Assets		
	As per last Balance Sheet	55,00,000	
	Taken over on absorption of P Ltd.	28,00,000	83,00,000
5.	Intangible assets		
	Goodwill (See Working Note)		8,10,000
6.	Current Assets		
	As per last Balance Sheet	25,00,000	
	Taken over on absorption of P Ltd. ₹ (23,00,000-2,00,000)	21,00,000	46,00,000

Working Note:

Calculation of Goodwill on Absorption

		₹
Purchase consideration		47,50,000
Fixed assets taken over [27,00,000 + 1,00,000]	28,00,000	
Current assets taken over [23,00,000 – 2,00,000]	21,00,000	
	49,00,000	
Less: Current liabilities [10,00,000 – 40,000]	(9,60,000)	
Net assets taken over		(39,40,000)
Goodwill		8,10,000

Question 10

A Ltd. agreed to take over B Ltd. as on 1st October, 2016. No Balance Sheet of B was prepared on that date:

Summarised Balance Sheets of A and B as at 31st March, 2016 were as follows:

	A ₹	B ₹		A ₹	B ₹
Share Capital:			*Fixed Assets*	*12,50,000*	*8,75,000*
Equity shares of ₹ 10 each fully paid up	*15,00,000*	*10,00,000*	*Current Assets:* *Inventory*	*2,37,500*	*1,87,500*
Reserves and Surplus:			*Trade receivables*	*3,90,000*	*2,56,000*
Reserve	*4,15,000*	*2,56,000*	*Bank*	*2,93,750*	*1,50,000*
Profit and Loss	*1,62,500*	*1,37,500*			
Trade payables	*93,750*	*75,000*			
	21,71,250	*14,68,500*		*21,71,250*	*14,68,500*

Additional information available:

(i) For the six months period from 1st April, 2016, A made a profit of ₹ 4,20,000 after writing off depreciation at 10% per annum on its fixed assets.

(ii) For the same period, B made a net profit of ₹ 2,04,000 after writing off depreciation at 10% p.a. on its fixed assets.

(iii) Both the companies paid on 1st August, 2016, equity dividends of 15%. Tax at 10% on such payments was also paid by each of them.

(iv) Goodwill of B was valued at ₹ 1,20,000 on the date of take-over; inventory of B, subject to an abnormal item of ₹ 7,500 to be fully written off, would be appreciated by 25% for purpose of take-over:

(v) A to issue to B's shareholders fully paid equity shares of ₹ 10 each, on the basis of the comparative intrinsic values of the shares on the take-over date.

Draft the Balance Sheet of A after absorption of B. All workings are to form part of your answer.

Answer

Balance Sheet of A Ltd. (after absorption of B Ltd.)

Particulars	*Note No.*	*₹*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	25,60,000
(b) Reserves and Surplus	2	12,80,000
(2) **Current Liabilities**		
Trade payables		1,68,750
Total		40,08,750
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	3	20,18,750
ii. Intangible assets	4	1,20,000
(2) **Current assets**		
(a) Inventories (₹ 2,37,500 + ₹ 2,25,000)		4,62,500
(b) Trade receivables (₹ 3,90,000 + ₹ 2,56,000)		6,46,000
(c) Cash and cash equivalents (₹ 5,28,750 + ₹ 2,32,750)		7,61,500
Total		40,08,750

Notes to Accounts

		₹	₹
1.	Share Capital		
	2,56,000 Equity Shares of ₹ 10 each fully paid		25,60,000
	(1,06,000 shares allotted as fully paid without payment being received in cash)		
2.	Reserves and surplus		
	Securities Premium	5,30,000	
	Reserves	4,15,000	
	Profit and Loss Account	3,35,000	12,80,000
3.	Tangible Assets		
	Other Fixed Assets (₹ 12,50,000 + ₹ 8,75,000)	21,25,000	
	Less: Depreciation	(1,06,250)	20,18,750
4.	Intangible assets		
	Goodwill		1,20,000

Working Notes:

(1) Bank Balance on 1.10.2016

	A Ltd. ₹	*B Ltd.* ₹
Bank Balance as on 31.3.2016	2,93,750	1,50,000
Add: Net Profit	4,20,000	2,04,000
Depreciation	62,500	43,750
	[12,50,000 × 10 % ×6/12]	[8,75,000 × 10 % × 6/12]
	7,76,250	3,97,750
Less: Dividend	(2,25,000)	(1,50,000)
	[15,00,000 × 15 %]	[10,00,000 × 15 %]
	5,51,250	2,47,750
Less: Dividend Tax @ 10 % on dividend	(22,500)	(15,000)
Bank Balance as on 1.10.2016	5,28,750	2,32,750

(2) Profit and Loss Account as on 1.10.2016

	A Ltd. ₹	*B Ltd.* ₹
Balance as on 31.3.2016	1,62,500	1,37,500

Add: 6 months' profit	4,20,000	2,04,000
	5,82,500	3,41,500
Less: Dividend	(2,25,000)	(1,50,000)
Dividend tax	(22,500)	(15,000)
Balance	3,35,000	1,76,500

(3) **Balance Sheets of A Ltd. and B Ltd. as on 1st October, 2016 (before absorption)**

Particulars	*Note no.*	*A Ltd. (₹)*	*B Ltd. (₹)*
I. **Equity and Liabilities**			
(1) **Shareholder's Funds**			
(a) Share Capital		15,00,000	10,00,000
(b) Reserves and Surplus	1	7,50,000	4,32,500
(2) **Current Liabilities**			
Trade payables		93,750	75,000
Total		23,43,750	15,07,500
II. **Assets**			
(1) **Non-current assets**			
(a) Fixed assets			
Tangible assets	2	11,87,500	8,31,250
(2) **Current assets**			
(a) Inventories*		2,37,500	1,87,500
(b) Trade receivables*		3,90,000	2,56,000
(c) Cash and cash equivalents [WN 1]		5,28,750	2,32,750
Total		23,43,750	15,07,500

*It is assumed that these amounts as on 1st October, 2016 are same in the absence of any other information.

Notes to Accounts

		A Ltd.		*B Ltd.*	
		(₹)	*(₹)*	*(₹)*	*(₹)*
1.	Reserves and surplus				
	Reserves	4,15,000		2,56,000	
	Profit and Loss A/c	3,35,000	7,50,000	1,76,500	4,32,500

2.	Tangible Assets				
	Fixed Assets	12,50,000		8,75,000	
	Less: Depreciation	(62,500)		(43,750)	
	Net Fixed Assets		11,87,500		8,31,250

(4) **Purchase consideration**

	A Ltd. ₹	*B Ltd.* ₹
Goodwill	–	1,20,000
Fixed Assets	11,87,500	8,31,250
Inventory	2,37,500	2,25,000
		[1,87,500 – 7,500] x 125 %
Trade receivables	3,90,000	2,56,000
Bank Balance	5,28,750	2,32,750
	23,43,750	16,65,000
Less: Trade payables	(93,750)	(75,000)
Net Assets	22,50,000	15,90,000
Number of Shares	1,50,000	1,00,000
Intrinsic value	15.00	15.90

Purchase consideration ₹ 15,90,000 in the form of Share capital ₹ 10,60,000 and securities premium ₹ 5,30,000. i.e. 1,06,000 shares of A Ltd.

Question 11

The following are the summarized Balance Sheets of A Ltd. and B Ltd. as on 31st December, 2016:

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*	*Investment:*		
10% Pref. Shares of ₹ 100 each	*2,00,000*	*1,00,000*	*6,000 Shares of B Ltd.*	*80,000*	–
			5,000 Shares of A Ltd.	–	*80,000*
Reserves and Surplus	*3,00,000*	*2,00,000*			

Secured Loans:			*Current Assets:*		
12% Debentures	*2,00,000*	*1,50,000*	*Inventory*	*2,40,000*	*3,20,000*
Current Liabilities:			*Trade receivables*	*4,20,000*	*2,10,000*
Trade payables	*2,50,000*	*1,50,000*	*Cash at Bank*	*1,10,000*	*40,000*
	15,50,000	*9,00,000*		*15,50,000*	*9,00,000*

Fixed Assets of both the companies are to be revalued at 15% above book value. Inventory in Trade and Trade receivables 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% Debenture holders 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. Trade payables 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.

Answer

(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)			
Bank Account	Dr.	6,000	
To Reserves and Surplus			6,000
(Dividend received from B Ltd. on 6,000 shares)			
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.	3,90,000	
To Liquidator of B Ltd.			3,90,000
(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	
Trade receivables	Dr.	2,10,000	
Cash at Bank (₹ 40,000 – ₹ 30,000 dividend paid + ₹ 5,000 dividend received)	Dr.	15,000	
To Provision for Bad Debts (5% of ₹ 2,10,000)			10,500
To Trade payables			1,50,000
To 12% Debentures in B Ltd.			1,62,000
To Business Purchase Account			3,90,000
To Investments in B Ltd.			80,000
To Capital Reserve (Balancing figure)			24,000
(Incorporation of various assets and liabilities taken over from B Ltd. at agreed values and cancellation of investment in B Ltd. account, profit being credited to capital reserve)			
Liquidator of B Ltd.	Dr.	3,90,000	
To Equity Share Capital			2,70,000
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)			

Trade payables	Dr.	10,000	
To Trade receivables			10,000
(Cancellation of mutual owing)			
Reserves and Surplus		18,000	
To Discount on issue of Debentures A/c			18,000
(Being discount on issue of debentures being adjusted against Reserves and surplus)			

(b) Statement of Consideration payable by A Ltd.

For equity shares held by outsiders

Shares held by them 30,000 – 6,000 = 24,000

Shares to be allotted $\frac{24,000}{6} \times 8 = 32,000$

as 5,000 shares are already with B Ltd; i.e. A Ltd. will now issue only 27,000 shares of

₹ 10 each i.e ₹ 2,70,000 (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)] ₹ 3,60,000

Note: It has been assumed that dividend on equity shares have been paid by both the companies.

Question 12

The following was the abridged Balance Sheet of X Co. Ltd, as at 31st March, 2016:

Liabilities	₹	*Assets*	₹
Capital:		*Plant and machinery at depreciated value*	*8,60,000*
Authorized:			
10,000 Equity shares of ₹ 100 each	*10,00,000*	*Land*	*7,00,000*
Issued and paid up:		*Current assets*	
8,000 Equity shares of ₹ 100 each, fully paid up	*8,00,000*	*Trade receivables*	*8,00,000*
		Patents, trademarks and copyrights	*6,00,000*
Reserves and surplus:			
General reserve 5,00,000			
Securities premium 4,00,000			
Profit and loss 3,60,000	*12,60,000*		
11% Debentures secured against the			

assets of the Co.	*5,00,000*		
Trade payables	*4,00,000*		
	29,60,000		*29,60,000*

The Company ran two distinct departments utilizing the trademarks and copyrights owned and generated by it. The assets and liabilities of one of the departments as on the date of Balance Sheet were:

	₹
Plant and machinery	*4,00,000*
Land (used for business)	*2,00,000*
Current assets	*2,00,000*
Trademarks and copyrights	*3,50,000*
	11,50,000
Trade payables	*2,50,000*
	9,00,000

Due to managerial constraints, X is unable to develop this department. An overseas buyer is interested to acquire this department and after due diligence, offers a consideration of ₹ 20,00,000 to the company for transfer of business. The buyer offered to discharge the purchase consideration immediately after 31st March, 2016, in the following manner:

(i) *Issue of equity shares of the buyer's company for ₹ 10,00,000 nominal value at a premium of 20% over the face value; and*

(ii) *Payment of the balance consideration in £ Sterling. The exchange rate agreed upon is ₹ 80 per £ Sterling. This amount will be retained in London, till the actual takeover of the business is done by the buyer.*

(a) *expenses to put through the transaction come to ₹ 8,00,000 initially to be incurred by X but to be shared equally by the parties.*

(b) *the balance value of trademarks, copyrights and patents left with X does not enjoy any market value and has to be written off.*

(c) *the value of the balance of land in X's possession will be taken at its market value in the books of account. Such a value, determined by an approved valuer, is 200 percent of the book value.*

(d) *the parties agree that the date of legal ownership of the transferred business shall be 31st March, 2016, though certain formalities may have to be gone through and agree that the actual transfer to the buyer will be effected before 30th April, 2016.*

X Co. Ltd to carry on the business in the normal course and account for the profits of the transferred department to the foreign buyer. X made a net profit of

₹ 2,40,000 from the whole business for April, 2016; 40 percent of the net profit related to the business of the transferred department.

(e) the shares of the overseas buyer's company were quoted on the London Stock Exchange and on 30th April, 2016 were quoted at 95 percent of their face value.

(f) the cash received by X at London was remitted by it to its Indian banking account on 30th April 2016 when the rupee sterling rate was ₹ 75 per UK sterling pound.

Draw the Balance Sheet of X Co. Ltd. as at 30th April, 2016, after the transfer of the business to the overseas buyer.

Answer

Balance Sheet of X Co. Ltd. as at 30th April, 2016 (after demerger)

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	8,00,000
(b) Reserves and Surplus	2	20,54,000
(2) **Non-Current Liabilities**		
Long-term borrowings	3	5,00,000
(3) **Current Liabilities**		
Trade payables		1,50,000
Total		35,04,000
II. Assets		
(1) Non-current assets		
Fixed assets		
Tangible assets	4	14,60,000
(2) Current assets		
(a) Trade receivables (8,00,000-2,00,000)		6,00,000
(b) Current investment		9,50,000
(c) Cash and cash equivalents (W.N.2)		4,94,000
Total		35,04,000

Notes to Accounts

		₹	₹
1.	Share Capital		
	Authorised share capital:		
	10,000 Equity shares of ₹ 100 each	10,00,000	

	Issued share capital:		
	8,000 Equity shares of ₹ 100 each		8,00,000
2.	Reserves and surplus		
	Revaluation reserve (W.N.6)	5,00,000	
	General reserve	5,00,000	
	Capital reserve (W.N.3)	11,00,000	
	Securities Premium	4,00,000	
	Profit and Loss Account (W.N.1)	(4,46,000)	20,54,000
3.	Long-term Borrowings		
	Secured borrowings		
	11% Debentures secured against the assets of the Co.		5,00,000
4.	Tangible Assets		
	Plant & Machinery at depreciated value (8,60,000-4,00,000)	4,60,000	
	Land (W.N.6)	10,00,000	14,60,000

Working Notes:

1. Computation of Profit and Loss Account as on 30th April, 2016

		₹
Balance as on 31st March, 2016		3,60,000
Add: Profit earned during the month of April, 2016 (W.N.4)		1,44,000
		5,04,000
Less: Expenses on sale of department (share of X Co.) (₹ 8,00,000 x 50%)	4,00,000	
Patents, trademarks and copyrights written off (W.N.5)	2,50,000	
Diminution in the value of investment (W.N.7)	2,50,000	
Loss due to on foreign exchange translation difference (W.N.8)	50,000	(9,50,000)
		(4,46,000)

2. Cash and bank

		₹
Cash received from Overseas buyer on 30th April, 2016 (£ 10,000 x ₹ 75)		7,50,000
Add: Cash reimbursed by Overseas buyer (₹ 8,00,000x50%)		4,00,000
Cash profit earned during the month of April, 2016 by X Co. Ltd. (See Note)		2,40,000
		13,90,000

Less: Expenses on sale of department to overseas buyer	8,00,000	
Share of profit (for April, 2016) paid to Overseas buyer (W.N.4)	96,000	(8,96,000)
		4,94,000

3. Calculation of gain on sale of department and discharge of purchase consideration

	₹
Purchase consideration	20,00,000
Less: Net assets sold	9,00,000
Gain on sale of department transferred to capital reserve	11,00,000
Purchase consideration	20,00,000
Less: Discharged by issue of Overseas Buyer's Equity shares of ₹ 10,00,000 at 20% premium	12,00,000
Balance discharged in cash i.e. (8,00,000/80) = £ 10,000	8,00,000

4. Profit earned during the month of April, 2016

	₹
Total profit earned by X Co. Ltd. during the month of April, 2016	2,40,000
Less: 40% Profit of the sold department	96,000
Profit of X Co. Ltd. on the retained department	1,44,000

5. Patents, trademarks and copyrights written off

	₹
Patents, trademarks and copyrights as per balance sheet of X Co. Ltd.	6,00,000
Less: Patents, trademarks and copyrights taken over by Overseas buyer	(3,50,000)
Patents, trademarks and copyrights written off (charged to Profit and Loss Account)	2,50,000

6. Land

	₹
Land as per balance sheet of X Co. Ltd.	7,00,000
Less: Land taken over by Overseas buyer	(2,00,000)
Book value of land retained by X Co. Ltd.	5,00,000
Revalued value (200% of book value)	10,00,000
Revaluation reserve (10,00,000-5,00,000)	5,00,000

7. Diminution in the market value of equity shares of Overseas Buyer

	₹
Nominal value of shares	10,00,000
Issued at 20% Premium	12,00,000
Market value of shares on 30th April, 2016 is 95% of nominal value (10,00,000 x 95%)	9,50,000
Diminution charged to Profit and Loss Account	2,50,000

8. Loss due to foreign exchange translation difference

	₹
Cash payment by overseas buyer £ 10,000 due on 31st March, 2016 @ ₹ 80 per £	8,00,000
Exchange rate on 30th April, 2016 is ₹ 75 per £	
Less: Amount remitted in Indian Currency (£ 10,000 x ₹ 75)	(7,50,000)
Loss on foreign exchange translation transferred to Profit and Loss Account	50,000

Note:

1. The above solution has been given on the assumption that X Co. Ltd intends to hold investment in shares of overseas buyer as temporary investment. Therefore, its carrying value has been shown in the balance sheet at market value and reduction to market value has been included in the profit and loss account. In case it is assumed as long term investment, then investment in shares of Overseas buyer will be shown at cost i.e. ₹ 12,00,000 and Profit and Loss account balance will be ₹ 9,04,000. The Balance Sheet total will be ₹ 37,54,000.
2. It is also assumed that the profit earned during the month of April, 2016 is entirely the cash profit and also the amount of current assets and current liabilities of X Co. Ltd. has been same as on 31.3.2016.

Question 13

The summarized Balance sheets of X Ltd. and its subsidiary Y Ltd. as at 31.3.2016 were as follows:

Liabilities	*X Ltd. ₹*	*Y Ltd. ₹*	*Assets*	*X Ltd. ₹*	*Y Ltd. ₹*
Share capital	*50,00,000*	*10,00,000*	*Fixed assets*	*60,00,000*	*18,00,000*
(Share of ₹ 10 each)			*Investment in Y Ltd. (60,000 shares)*	*6,00,000*	*---*
General reserves	*50,00,000*	*20,00,000*	*Trade receivables*	*35,00,000*	*5,00,000*
Profit and Loss account	*20,00,000*	*15,00,000*	*Inventories*	*30,00,000*	*25,00,000*

Secured loan	*20,00,000*	*2,50,000*	*Cash and bank*	*39,00,000*	*2,00,000*
Current liabilities	*30,00,000*	*2,50,000*			
	1,70,00,000	*50,00,000*		*1,70,00,000*	*50,00,000*

X Ltd. holds 60% of the paid-up capital of Y Ltd. and the balance is held by a foreign company.

A memorandum of understanding has been entered into with the foreign company by X Ltd. to the following effect:

(i) The shares held by the foreign company will be sold to X Ltd. at a price per share to be calculated by capitalizing the yield at 15%. Yield, for this purpose, would mean 50% of the average of pre-tax profits for the last 3 years, which were ₹ 12 lakhs, 18 lakhs and 24 lakhs respectively. (Average tax rate was 40%).

(ii) The actual cost of shares to the foreign company was ₹ 4,40,000 only. Gains accruing to the foreign company are taxable at 20%. The tax payable will be deducted from the sale proceeds and paid to government by X. 50% of the consideration (after payment of tax) will be remitted to the foreign company by X Ltd. and also any cash for fractional shares allotted.

(iii) For the balance of consideration, X Ltd. would issue its shares at their intrinsic value.

It was also decided that X Ltd. would absorb Y Ltd. Simultaneously by writing down the Fixed assets of Y Ltd. by 10%. The Balance Sheet figures included a sum of ₹ 1,00,000 due by Y Ltd. to X Ltd. and inventory of X Ltd. included inventory of ₹ 1,50,000 purchased from Y Ltd., who sold them at cost plus 20%.

The entire arrangement was approved and put through by all concern effective from 1.4.2016.

You are required to prepare a Balance Sheet after absorption of Y Ltd., in the books of X Ltd. Workings should form part of your answer.

Answer

X Ltd.

Balance Sheet as at 1st April, 2016

Particulars	*Note No.*	*Amount (₹)*
I. Equity and Liabilities		
(1) **Shareholder's Funds**		
(a) Share Capital	1	53,34,660
(b) Reserves and Surplus	2	89,64,320
(2) **Non-Current Liabilities**		
Long-term borrowings	3	22,50,000
(3) **Current Liabilities**	4	31,50,000
Total		1,96,98,980

II.	**Assets**		
	(1) **Non-current assets**		
	(a) Fixed assets		
	Tangible assets	5	76,20,000
	(2) **Current assets**		
	(a) Inventories	6	54,75,000
	(b) Trade receivables	7	39,00,000
	(c) Cash and cash equivalents		27,03,980
	Total		1,96,98,980

Notes to Accounts

		`	`
1.	Share Capital		
	5,33,466 shares of ₹ 10 each		53,34,660
	(Out of the above 33,466 shares of ₹ 10 each issued for consideration other than cash)		
2.	Reserves and surplus		
	General Reserve	50,00,000	
	Capital Reserve	13,20,000	
	Profit and Loss Account ₹20,00,000		
	Less: unrealized profit on inventory (₹25,000)	19,75,000	
	Securities Premium (₹33,466×20)	6,69,320	89,64,320
3.	Long Term Borrowings		
	Secured Loans (₹20,00,000 + ₹2,50,000)		22,50,000
4.	Current Liabilities		
	(₹30,00,000 + ₹2,50,000)	32,50,000	
	Less: Mutual owing	(1,00,000)	31,50,000
5.	Tangible Assets		
	Fixed Assets	78,00,000	
	Less : Revaluation loss	(1,80,000)	76,20,000
6.	Inventories (₹30,00,000+₹25,00,000)	55,00,000	
	Less: Unrealised profit on inventory	(25,000)	54,75,000

7.	Trade receivables		
	Trade receivables (₹35,00,000+₹5,00,000)	40,00,000	
	Less: Mutual owings	(1,00,000)	39,00,000

Working Notes:

(1) Yield of Y Ltd.

Average of Pre Tax Profit $= \frac{12+18+24}{3} =$ ₹ 18 lakhs*

Yield $= 18 \times \frac{50}{100} =$ ₹ 9 lakhs

(2) Price per share of Y Ltd:-

Capitaised value of yield of Y Ltd. $= \frac{9 \text{ lakhs}}{15} \times 100 =$ ₹ 60 lakhs

No. of shares = 1,00,000

Price per share $= \frac{60 \text{ lakhs}}{1 \text{ lakh}} =$ ₹ 60 per share

(3) Purchase consideration for 40% of share capital of Y Ltd.

$= 1,00,000 \times 60 \times \frac{40}{100} =$ ₹ 24,00,000

(4) Calculation of intrinsic value of shares of X Ltd.

		₹
Total Assets excluding Investments in Y Ltd.		1,64,00,000
Value of Investment 60,000 × ₹60		36,00,000
		2,00,00,000
Less: Outside Liabilities:		
Secured Loan	20,00,000	
Current Liabilities	30,00,000	(50,00,000)
Net Assets		1,50,00,000

Intrinsic value per share $= \frac{\text{Net Assets}}{\text{No. of Shares}} = \frac{₹\,1,50,00,000}{5,00,000} =$ ₹ 30 per share

* By setting the trend, weighted average profit can also be calculated.

(5) Discharge of purchase consideration by X Ltd.

		Equity share capital ₹	*Cash* ₹	*Total* ₹
(i)	Payment of Tax (₹ 24 Lakh - ₹ 4.40 Lakh) x $\frac{20}{100}$ =	---	3,92,000	3,92,000
(ii)	Issue of shares to foreign company			
	[50% of (24 Lakh – 3.92 Lakh) = 10.04 lakhs			
	No. of shares issued by X Ltd. $\frac{10,04,000}{30}$ = 33,466.6666 shares			
	Value of shares capital = 33,466 × ₹ 30 =	10,03,980	---	10,03,980
(iii)	Cash Payment [50% of (₹ 24 Lakh – ₹ 3.92 Lakh) = 10.04 lakhs	---	10,04,000	10,04,000
(iv)	Cash for fractional shares = 0.6666 × ₹ 30	---	20	20
	Total	10,03,980	13,96,020	24,00,000

(6) Calculation for Goodwill/Capital Reserve to X Ltd.

		₹
Total of assets as per Balance Sheet of Y Ltd.		50,00,000
Less: 10% Reduction in the value of Fixed Assets $\left(\frac{10}{100}\times 18,00,000\right)$		(1,80,000)
		48,20,000
Less: Secured Loan	2,50,000	
Current Liabilities	2,50,000	(5,00,000)
Net Assets		43,20,000
Less: Purchase consideration (outside shareholders)		(24,00,000)
		19,20,000
Less: Investment in Y Ltd. as per Balance Sheet of X Ltd.		(6,00,000)
Capital Reserve		13,20,000

(7) Cash and Bank Balance of X Ltd. after acquisition of shares

	₹
Opening Balance (X Ltd.)	39,00,000
Cash and Bank Balance of Y Ltd.	2,00,000
	41,00,000
Less: Remittance to the foreign company	(10,04,020)
	30,95,980
Less: T.D.S. paid to Government	(3,92,000)
	27,03,980

(8) Unrealized profit included in inventory of X Ltd. =₹ 1,50,000 **x** $\frac{20}{120}$ = ₹ 25,000

Question 14

The following are the summarized Balance sheets (as at 31.3.2016) of A Ltd. and B Ltd.:

Liabilities	*A Ltd.* ₹	*B. Ltd.* ₹	*Assets*	*A Ltd.* ₹	*B. Ltd.* ₹
Share Capital:			***Fixed Assets***	*50,00,000*	*30,00,000*
Equity Shares of ₹ 10 each	*36,00,000*	*18,00,000*	*Investments*	*5,00,000*	*5,00,000*
			Current Assets		
10% Preference shares of ₹ 100 each	*12,00,000*	-	*Inventory*	*18,00,000*	*12,00,000*
			Trade receivables	*15,50,000*	*12,10,000*
12% Preference shares of ₹ 100 each	-	*6,00,000*	*Cash at Bank*	*1,50,000*	*90,000*
Reserves and Surplus:					
Statutory Reserve	*1,00,000*	*1,00,000*			
General Reserve	*25,00,000*	*17,00,000*			
Secured Loan					
15% Debentures	*5,00,000*	-			
12% Debentures	-	*5,00,000*			
Current Liabilities					
Trade payables	*11,00,000*	*13,00,000*			
	90,00,000	*60,00,000*		*90,00,000*	*60,00,000*

Contingent liabilities for bills receivable discounted ₹ 20,000.

(A) The following additional information is provided to you:

	A Ltd. ₹	B Ltd. ₹
Profit before Interest and Tax	14,75,000	7,80,000
Rate of Income-tax	40%	40%
Preference dividend	1,20,000	72,000
Equity dividend	3,60,000	2,70,000
Balance profit transferred to Reserve account.		

(B) The equity shares of both the companies are quoted on the Mumbai Stock Exchange. Both the companies are carrying on similar manufacturing operations.

(C) A Ltd proposes to absorb business of B Ltd. as on 31.3.2016. The agreed terms for absorption are:

(i) 12% Preference shareholders of B Ltd. will receive 10% Preference shares of A Ltd. sufficient to increase their present income by 20%.

(ii) The Equity shareholders of B Ltd. will receive equity shares of A Ltd. on the following terms:

(a) The Equity shares of B Ltd. will be valued by applying to the earnings per share of B Ltd. 60 per cent of price earnings ratio of A Ltd. based on the results of 2015-2016 of both the Companies.

(b) The market price of Equity shares of A Ltd. is ₹ 40 per share.

(c) The number of shares to be issued to Equity shareholders of B Ltd. will be based on 80% of market price.

(d) In addition to Equity shares, 10% Preference shares of A Ltd. will be issued to the equity shareholders of B Ltd. to make up for the loss in income arising from the above exchange of shares based on the dividends for the year 2015-2016.

(iii) 12% Debenture holders of B Ltd. are to be paid at 8% premium by 15% debentures in A Ltd. issued at a discount of 10%.

(iv) Details of Trade payables and Trade receivables:

	A Ltd.	B Ltd.
Trade payables		
Bills Payable	20,000	20,000
Sundry creditors	10,80,000	12,80,000
	11,00,000	13,00,000

Trade receivables		
Debtors	*15,00,000*	*12,00,000*
Bills Receivables	*50,000*	*10,000*
	15,50,000	*12,10,000*

(v) ₹ 16,000 is to be paid by A Ltd. to B Ltd. for liquidation expenses. Sundry creditors of B Ltd. include ₹ 20,000 due to A Ltd. Bills receivable discounted by A Ltd. were all accepted by B Ltd.

(vi) Fixed assets of both the companies are to be revalued at 20% above book value. Inventory in trade is taken over at 10% less than their book value.

(vii) Statutory reserve has to be maintained for two more years.

(viii) For the next two years no increase in the rate of equity dividend is anticipated.

(ix) Liquidation expense is to be considered as part of purchase consideration.

You are required to:

(i) Find out the purchase consideration.

(ii) Give journal entries in the books of A Ltd.

(iii) Give the Balance Sheet as at 31.3.2016 after absorption.

Answer

(i) Computation of Purchase Consideration

	₹
For Preference Shareholders	
Present Income of Preference Shareholders of B Ltd. (6,00,000× 12%)	72,000
Add: Required 20% increase	14,400
	86,400
10% Preference Shares to be issued of ₹ 8,64,000 (86,400/10x100)	8,64,000
For Equity Shareholders	
Valuation of Equity Shares of B Ltd. = Number of shares x Value of one share (i.e. EPS of B Ltd. x P/E ratio of A Ltd. [W.N.1] x 60/100)	
$= 1,80,000 \text{ x } \left(₹\, 2\times20\times\frac{60}{100}\right) = 1,80,000 \text{ x } 24 = ₹\ 43,20,000$	

Issue of Equity Shares	
No. of Equity Shares to be issued at 80% of Market Price i.e.	
80% of ₹ 40 = ₹ 32	
$\frac{43,20,000}{32}$ = 1,35,000 shares	
Equity Share Capital = 1,35,000 x ₹ 10 = ₹ 13,50,000	
Securities Premium = 1,35,000 x ₹ 22 = ₹ 29,70,000	
₹ 43,20,000	43,20,000
Issue of Preference Shares	₹
Present Equity Dividend	2,70,000
Less: Expected Equity Dividend from A Ltd. $\left(13,50,000 \times \frac{10}{100}\right)$	(1,35,000)
Loss in income	1,35,000
10% Preference Shares to be issued of ₹ 13,50,000 (1,35,000/10x 100)	13,50,000
Purchase Consideration	
Preference Shares Capital [₹ 8,64,000 + ₹ 13,50,000]	22,14,000
Equity Share Capital (1,35,000 shares of ₹ 10 each at ₹ 32 per share)	43,20,000
Liquidation Expenses (in cash)	16,000
	65,50,000

Note: For calculation of purchase consideration also 80% of market price has been considered as value of shares.

(ii) Journal Entries in the Books of A Ltd.

	Particulars		*Dr. (₹).*	*Cr. (₹)*
1.	Fixed Assets A/c [50,00,000 x 20 %]	Dr.	10,00,000	
	To Revaluation Reserve			10,00,000
	(Being Revaluation of Fixed assets at 20% above book value)			
2.	Business Purchase A/c	Dr.	65,50,000	
	To Liquidator of B Ltd.			65,50,000
	(Being purchase consideration payable for the business taken over from B Ltd.			
3.	Fixed Assets A/c [30,00,000 x 120 %]	Dr.	36,00,000	
	Investment A/c	Dr.	5,00,000	
	Inventory A/c [12,00,000 x 90 %]	Dr.	10,80,000	

	Sundry Debtors A/c	Dr.	12,00,000	
	Bills Receivable A/c	Dr.	10,000	
	Cash at Bank A/c	Dr.	90,000	
	Goodwill A/c (Balancing figure)	Dr.	19,10,000	
	To 12% Debentures in B Ltd. [5,00,000 x 108%]			5,40,000
	To Sundry Creditors A/c			12,80,000
	To Bills Payable A/c			20,000
	To Business Purchase A/c			65,50,000
	(Being incorporation of different assets and liabilities of B Ltd. taken over at agreed values and balance debited to goodwill account)			
4.	Liquidator of B Ltd.	Dr.	65,50,000	
	To Equity Share Capital A/c			13,50,000
	To Securities Premium A/c			29,70,000
	To Preference Share Capital A/c			22,14,000
	To Bank A/c [Liquidation expenses]			16,000
	(Being discharge of consideration for B Ltd's business)			
5.	12% Debentures in B Ltd.	Dr.	5,40,000	
	Discount on issue of Debentures	Dr.	60,000	
	To 15% Debentures			6,00,000
	(Being allotment of 15% Debentures to debenture holders at a discount of 10% to discharge liability of B Ltd. debentures)			
6.	Sundry Creditors A/c	Dr.	20,000	
	To Sundry Debtors A/c			20,000
	(Being cancellation of Mutual owing)			
7.	Amalgamation Adjustment A/c	Dr.	1,00,000	
	To Statutory Reserve A/c			1,00,000
	(Being statutory reserve account is maintained under statutory requirements)			
8.	Securities Premium A/c	Dr.	60,000	
	To Discount on issue of Debentures A/c			60,000
	(Being discount on issue of Debentures written off out of securities premium)			

(iii) Balance Sheet of A Ltd (after absorption of B Ltd.) as on 31.3.2016

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	83,64,000
(b) Reserves and Surplus	2	66,10,000
(2) **Non-Current Liabilities**		
Long-term borrowings	3	11,00,000
(3) **Current Liabilities**		
Trade payables	4	23,80,000
Total		1,84,54,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	5	96,00,000
ii. Intangible assets	6	19,10,000
(b) Non-current investments	7	10,00,000
(c) Other non-current assets	8	1,00,000
(2) **Current assets**		
(a) Inventories	9	28,80,000
(b) Trade receivables	10	27,40,000
(c) Cash and cash equivalents [1,50,000+90,000-16,000]		2,24,000
Total		1,84,54,000

Notes to Accounts

		`	`
1.	Share Capital		
	4,95,000 Equity shares of ₹ 10 each fully paid	49,50,000	
	(1,35,000 shares have been allotted as fully		

	paid-up for consideration other than cash)		
	10%, 34,140 Preference shares of ₹ 100 each fully paid	34,14,000	83,64,000
	(Out of the above, 22,140 preference shares of ₹ 100 each have been allotted as fully paid up for consideration other than cash)		
2.	Reserves and surplus		
	Statutory reserve [1,00,000 + 1,00,000]	2,00,000	
	Revaluation reserve [Journal Entry 1 above]	10,00,000	
	General reserve	25,00,000	
	Securities Premium [29,70,000 – 60,000]	29,10,000	66,10,000
3.	Long Term Borrowings		
	Secured borrowings		
	15% Debentures (₹5,00,000 + ₹6,00,000)		11,00,000
4.	Trade payables		
	Creditors (10,80,000 + 12,80,000 -20,000)	23,40,000	
	Bills Payable (20,000+20,000)	40,000	23,80,000
5.	Tangible Assets		
	Other Fixed Assets (₹ 60,00,000+₹ 36,00,000)		96,00,000
6.	Intangible assets		
	Goodwill		19,10,000
7.	Non-current Investment		
	Investment (₹ 5,00,000+₹ 5,00,000)		10,00,000
8.	Other non-current assets		
	Amalgamation Adjustment A/c		1,00,000
9.	Inventories		
	Inventory (₹18,00,000+₹10,80,000)		28,80,000
10.	Trade receivables		
	Debtors (15,00,000 + 12,00,000 -20,000)	26,80,000	
	Bills Receivable (50,000+10,000)	60,000	27,40,000

Note: No footnote will appear for contingent liability as it has been converted into actual liability after absorption of B Ltd.

Working Notes:

1. Calculation of EPS & P/E ratio

	A Ltd. ₹	*B Ltd.* ₹
Profit before Interest and Tax	14,75,000	7,80,000
Less: Interest on debentures	(75,000)	(60,000)
Profit before tax	14,00,000	7,20,000
Less: Tax @ 40%	(5,60,000)	(2,88,000)
	8,40,000	4,32,000
Less: Preference Dividend	(1,20,000)	(72,000)
Earnings available for equity shareholders	7,20,000	3,60,000
Number of shares	3,60,000 shares	1,80,000 shares
EPS (Earnings/ No. of shares)	2	2
Market Price	₹ 40	Not given
P/E ratio	40/2 = 20	N.A.

2. Computation of Goodwill/Capital Reserve on absorption:

	₹	₹	₹
Purchase Consideration			65,50,000
Fixed Assets taken over	30,00,000		
Add: Increase by 20%	6,00,000	36,00,000	
Investments		5,00,000	
Current Assets:			
Inventory	12,00,000		
Less: Reduction in value by 10%	(1,20,000)		
	10,80,000		
Sundry Debtors	12,00,000		
Bills Receivable	10,000		
Cash at Bank	90,000	23,80,000	
		64,80,000	
Less: Outside Liabilities:			
12% Debentures at premium	5,40,000		
Sundry Creditors A/c	12,80,000		
Bills Payable A/c	20,000	(18,40,000)	46,40,000
Goodwill			19,10,000

Question 15

The summarized Balance Sheets of Strong Ltd. and Weak Ltd. as on 31.03.2016 is as below:

Summarised Balance Sheet as on 31.03.2016

Liabilities	*Strong Ltd. ₹*	*Weak Ltd. ₹*	*Assets*	*Strong Ltd. ₹*	*Weak Ltd. ₹*
Equity Share Capital (₹ 100 each)	*50,00,000*	*30,00,000*	*Fixed Assets other than Goodwill*	*30,00,000*	*20,00,000*
Reserve	*3,00,000*	*1,50,000*	*Inventory*	*8,00,000*	*6,00,000*
P/L A/c	*6,00,000*	*4,00,000*	*Trade receivables*	*14,00,000*	*9,00,000*
Trade payables	*5,00,000*	*3,00,000*	*Cash & Bank*	*12,00,000*	*3,50,000*
	64,00,000	*38,50,000*		*64,00,000*	*38,50,000*

Strong Ltd. takes over Weak Ltd. on 01.07.14. No Balance Sheet of Weak Ltd. is available as on that date. It is however estimated that Weak Ltd. earns estimated profit of ₹ 2,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets, during April-June, 2016.

Estimated profit of Strong Ltd. during these 3 months is ₹ 4,00,000 after charging proportionate depreciation @ 10% p.a. on fixed assets.

Both the companies have declared and paid 10% dividend within this 3 months' period. Goodwill of Weak Ltd. is valued at ₹ 2,00,000 and Fixed Assets are valued at ₹ 1,00,000 above the estimated book value. Purchase consideration is to be satisfied by Strong Ltd. by shares at par. Ignore Income-tax.

You are required to calculate the following:

(i) No. of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration;

(ii) Net Current Assets of Strong Ltd. and Weak Ltd. as on 01.07.2016;

(iii) P/L A/c balance of the Strong Ltd. as on 01.07.2016;

(iv) Fixed Assets as on 01.07.2016;

(v) Balance Sheet of Strong Ltd. as on 01.07.2016 after takeover of Weak Ltd.

Answer

(i) Number of shares to be issued by Strong Ltd. to Weak Ltd. against purchase consideration

Weak Ltd.	₹	₹
Goodwill		2,00,000
Fixed Assets	20,00,000	
Less: Depreciation [20,00,000 × 10 % × 3/12]	(50,000)	

	19,50,000	
Add: Appreciation	1,00,000	20,50,000
Inventory		6,00,000
Trade receivables		9,00,000
Cash and Bank balances	3,50,000	
Add: Profit after depreciation 2,00,000		
Add: Depreciation (non-cash) 50,000	2,50,000	
Less: Dividend [30,00,000 × 10%]	(3,00,000)	3,00,000
		40,50,000
Less: Trade payables		(3,00,000)
Purchase Consideration		37,50,000
Number of shares to be issued by Strong Ltd. @ ₹ 100 each		37,500 shares

(ii) Calculation of Net Current Assets as on 01.07.2016

	₹	*Strong Ltd.* ₹		*Weak Ltd.* ₹
Current assets:				
Inventory		8,00,000		6,00,000
Trade receivables		14,00,000		9,00,000
Cash and Bank	12,00,000		3,50,000	
Less: Dividend	(5,00,000)		(3,00,000)	
Add: Profit after depreciation	4,00,000		2,00,000	
Add : Depreciation being non cash	75,000	11,75,000	50,000	3,00,000
		33,75,000		18,00,000
Less: Trade payables		(5,00,000)		(3,00,000)
		28,75,000		15,00,000

(iii) Profit and Loss Account balance of Strong Ltd. as on 1.07.2016

	₹
P & L A/c balance as on 31.03.2016	6,00,000
Less: Dividend paid	(5,00,000)
	1,00,000
Add: Estimated profit for 3 months after charging depreciation	4,00,000
	5,00,000

(iv) Fixed Assets as on 01.07.2016

Fixed Assets of Strong Ltd. as on 31.03.2016		30,00,000
Less: Depreciation for 3 months [30,00,000 X 10% X 3/12]		(75,000)
		29,25,000
Fixed assets taken over of Weak Ltd. as on 31.03.2016	20,00,000	
Less: Proportionate depreciation for 3 months on fixed assets	(50,000)	
	19,50,000	
Add: Appreciation above the estimated book value	1,00,000	20,50,000
		49,75,000
Add: Goodwill		2,00,000
Total Fixed Assets as on 1.7.2016		51,75,000

(v) Balance Sheet of Strong Ltd. as on 01.07.2016 (after Take Over)

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	87,50,000
(b) Reserves and Surplus	2	8,00,000
(2) **Current Liabilities**		
Trade payables	3	8,00,000
Total		1,03,50,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	4	49,75,000
ii. Intangible assets	5	2,00,000
(2) **Current assets**		
(a) Inventories [8,00,000 + 6,00,000]		14,00,000
(b) Trade receivables [14,00,000 + 9,00,000]		23,00,000
(c) Cash and cash equivalents [11,75,000 + 3,00,000] – As per (ii) above		14,75,000
Total		1,03,50,000

Notes to Accounts:

		`	`
1.	Share Capital		
	87,500 (50,000+ 37,500) Equity shares of ₹ 100 each		87,50,000
	(Out of the above, 37,500 equity shares of ₹ 100 each has been issued for consideration other than cash)		
2.	Reserves and surplus		
	Reserves	3,00,000	
	Profit and Loss Account [as computed in (iii)]	5,00,000	8,00,000
3.	Trade payables (₹ 5,00,000 + ₹ 3,00,000)		8,00,000
4.	Tangible Assets		
	Fixed assets [as computed in (iv)]		49,75,000
5.	Intangible assets		
	Goodwill		2,00,000

Question 16

T. Ltd. and V. Ltd. propose to amalgamate. Their summarized balance sheets as at 31st March, 2016 were as follows:

Liabilities	*T. Ltd. ₹*	*V. Ltd. ₹*	*Assets*	*T. Ltd. ₹*	*V. Ltd. ₹*
Share capital:			*Fixed assets*		
Equity shares of ₹ 10 each	*15,00,000*	*6,00,000*	*Less: Depreciation*	*12,00,000*	*3,00,000*
General reserve	*6,00,000*	*60,000*	*Investments (fetching interest @ 6%)*	*3,00,000*	*-*
Profit & Loss A/c	*3,00,000*	*90,000*	*Inventory*	*6,00,000*	*3,90,000*
Trade payables	*3,00,000*	*1,50,000*	*Trade receivables*	*5,10,000*	*1,80,000*
			Cash and bank balances	*90,000*	*30,000*
	27,00,000	*9,00,000*		*27,00,000*	*9,00,000*

Their net profits (after taxation) were as follows:

Year	*T. Ltd.*	*V. Ltd.*
2013-2014	*3,90,000*	*1,35,000*
2014-2015	*3,75,000*	*1,20,000*
2015-2016	*4,50,000*	*1,68,000*

Normal trading profit may be considered as 15% on closing capital invested. Goodwill may be taken as 4 years' purchase of average super profits. The inventory of T. Ltd. and V. Ltd. are to be taken at ₹ 6,12,000 and ₹ 4,26,000 respectively for the purpose of amalgamation. W. Ltd. is formed for the purpose of amalgamation of two companies. Assume tax @ 40%.

(a) Suggest a scheme of capitalization of W. Ltd. and ratio of exchange of shares; and

(b) Draft the opening balance sheet of W. Ltd.

Answer

(a) Scheme of capitalization of W. Ltd. and ratio of exchange of shares

Computation of Net Assets of amalgamating companies

	T. Ltd. ₹	*V. Ltd.* ₹
Goodwill (W.N.2)	3,19,200	1,21,200
Fixed Assets	12,00,000	3,00,000
6% investments (Non-trade)	3,00,000	-
Inventory	6,12,000	4,26,000
Trade receivables	5,10,000	1,80,000
Cash and Bank Balances	90,000	30,000
	30,31,200	10,57,200
Less: trade payables	(3,00,000)	(1,50,000)
Net Assets	27,31,200	9,07,200
No. of Equity shares	1,50,000	60,000
Intrinsic value of a share	₹ 18.208	₹ 15.12
No of shares to be issued by W. Ltd to		
T. Ltd 1,50,000 x 18.208/10	2,73,120 shares	
V. Ltd 60,000 x 15.12/10		90,720 shares

In total 2,73,120 + 90,720 i.e. 3,63,840 shares will be issued by W. Ltd.

Ratio of exchange of shares will be as follows:

1. Holders of 1,50,000 equity shares of T Ltd. will get 2,73,120 shares in W. Ltd.
2. Similarly, holders of 60,000 equity shares of V Ltd. will get 90,720 shares in W. Ltd.

(b) **Opening Balance Sheet of W. Ltd.**

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
Share Capital	1	36,38,400
(2) **Current Liabilities**		
Trade payables [3,00,000 + 1,50,000]		4,50,000
Total		40,88,400
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	2	15,00,000
ii. Intangible assets	3	4,40,400
(b) Non-current investments	4	3,00,000
(2) **Current assets**		
(a) Inventories [6,12,000+ 4,26,000]		10,38,000
(b) Trade receivables [5,10,000 + 1,80,000]		6,90,000
(c) Cash and cash equivalents [90,000 + 30,000]		1,20,000
Total		40,88,400

Notes to Accounts

		(₹)
1.	Share Capital	
	Equity share capital	
	3,63,840 Equity shares of ₹ 10 each	36,38,400
	(Issued for consideration other than cash, pursuant to scheme of amalgamation)	
2.	Tangible Assets	
	Other Fixed Assets (₹12,00,000+₹3,00,000)	15,00,000
3.	Intangible assets	
	Goodwill (W.N.2) (₹3,19,200 +₹1,21,200)	4,40,400
4.	Non-current investments	
	6%Investments	3,00,000

Working Notes:

1. Calculation of closing trading capital employed on the basis of net assets

	T. Ltd. ₹	*V. Ltd.* ₹
Fixed Assets	12,00,000	3,00,000
Inventory	6,12,000	4,26,000
Trade receivables	5,10,000	1,80,000
Cash and Bank Balances	90,000	30,000
	24,12,000	9,36,000
Less: Trade payables	(3,00,000)	(1,50,000)
Net Assets	21,12,000	7,86,000

2. Calculation of value of goodwill

		T. Ltd. ₹	*V. Ltd.* ₹
(i)	Average Trading Profit		
	2013-2014	3,90,000	1,35,000
	2014-2015	3,75,000	1,20,000
	2015-2016	4,50,000	1,68,000
	Profit after tax	12,15,000	4,23,000
	Profit before tax @ 40%	20,25,000	7,05,000
	Add: Under valuation of closing inventory	12,000	36,000
		20,37,000	7,41,000
	Average of 3 years' profit before tax	6,79,000	2,47,000
	Less: Income from non-trade investments (₹ 3,00,000 x 6%)	(18,000)	-
	Average profit before tax	6,61,000	2,47,000
	Less: 40% tax	(2,64,400)	(98,800)
	Average profit after tax	3,96,600	1,48,200
(ii)	Super Profits		
	Average trading profit	3,96,600	1,48,200
	Less: Normal Profit		
	T. Ltd. ₹ 21,12,000 x 15%	(3,16,800)	

	V. Ltd ₹ 7,86,000 x 15%	______	(1,17,900)
	Super Profit	79,800	30,300
(iii)	Value of goodwill at 4 years' purchase of super profits	3,19,200	1,21,200

Note: It is assumed that investments are made before 2013-2014.

Question 17

The following are the summarized Balance Sheets of Andrew Ltd. and Barry Ltd., as at 31.12.2016:

Andrew Ltd.

Liabilities	*Amount (₹ '000)*	*Assets*	*Amount (₹ '000)*
Share capital		*Fixed assets*	*3,400*
3,00,000 Equity shares of ₹ 10 each *10,000 Preference shares of ₹ 100 each*	*3,000* *1,000*	*Inventory (pledged with secured loan trade payables)*	*18,400*
General reserve	*400*	*Other Current assets*	*3,600*
Secured loans (secured against		*Profit and Loss account*	*16,600*
pledge of inventories)	*16,000*		
Unsecured loans	*8,600*		
Current liabilities	*13,000*		
	42,000		*42,000*

Barry Ltd.

Liabilities	*Amount (₹ '000)*	*Assets*	*Amount (₹ '000)*
Share capital		*Fixed assets*	*6,800*
1,00,000 Equity shares of ₹ 10 each	*1,000*	*Current assets*	*9,600*
General reserve	*2,800*		
Secured loans	*8,000*		
Current liabilities	*4,600*		
	16,400		*16,400*

Both the companies go into liquidation and Charlie Ltd., is formed to take over their businesses. The following information is given:

(a) *All Current assets of two companies, except pledged inventory are taken over by Charlie Ltd. The realisable value of all current assets are 80% of book values in case of Andrew Ltd. and 70% for Barry Ltd. Fixed assets are taken over at book value.*

(b) *The break-up of Current liabilities is as follows:*

	Andrew Ltd. ₹	*Barry Ltd.* ₹
Statutory liabilities (including ₹ 22 lakhs in case of Andrew Ltd. in case of a claim not having been admitted shown as contingent liability)	*72,00,000*	*10,00,000*
Liability to employees	*30,00,000*	*18,00,000*

The balance of Current liability is miscellaneous trade payables.

(c) *Secured loans include ₹ 16,00,000 accrued interest in case of Barry Ltd.*

(d) *2,00,000 equity shares of ₹ 10 each are allotted by Charlie Ltd. at par against cash payment of entire face value to the shareholders of Andrew Ltd. and Barry Ltd. in the ratio of shares held by them in Andrew Ltd. and Barry Ltd.*

(e) *Preference shareholders are issued Equity shares worth ₹ 2,00,000 in lieu of present holdings.*

(f) *Secured loan payables agree to continue the balance amount of their loans to Charlie Ltd. after adjusting value of pledged security in case of Andrew Ltd. and after waiving 50% of interest due in the case of Barry Ltd.*

(g) *Unsecured loans are taken over by Charlie Ltd. at 25% of Loan amounts.*

(h) *Employees are issued fully paid Equity shares in Charlie Ltd. in full settlement of their dues.*

(i) *Statutory liabilities are taken over by Charlie Ltd. at full values and trade payables are taken over at 80% of the book value.*

Show the opening Balance Sheet of Charlie Ltd. Workings should be part of the answer.

Answer

Balance sheet of Charlie Ltd. as at 31st December, 2016

Particulars	*Note No.*	*(₹ '000)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
Share Capital	1	7,000
(2) **Non-Current Liabilities**		
Long-term borrowings	2	10,630

(3) **Current Liabilities**			
(a) Trade Payables		3	5,440
(b) Other current liabilities		7	8,200
	Total		31,270
II. **Assets**			
(1) **Non-current assets**			
(a) Fixed assets			
i. Tangible assets		4	10,200
ii. Intangible assets		5	9,470
(2) **Current assets**			
(a) Cash and cash equivalents			2,000
(b) Other current assets		6	9,600
	Total		31,270

Notes to Accounts

			(₹ 000)
1.	Share Capital		
	Issued, subscribed & Paid up:		
	7,00,000 equity shares of ₹ 10 each, fully paid up (W.N.5)		7,000
	(of the above 5,00,000 shares have been issued for consideration other than cash)		
2.	Long Term Borrowings		
	Secured loans (₹ 1,280 +₹ 7,200) – W.N. 2	8,480	
	Unsecured Loans (25% of ₹ 8,600)	2,150	10,630
3.	Trade Payables (W.N.1)		
	Andrew Ltd.	4,000	
	Barry Ltd.	1,440	5,440
4.	Tangible Assets		
	Fixed Assets (₹ 3,400 + ₹ 6,800)		10,200
5.	Intangible assets		
	Goodwill (W.N.4)		9,470

6.	Other Current Assets		
	Andrew Ltd.	2,880	
	Barry Ltd.	6,720	9,600
7.	Other Current liabilities		
	Andrew Ltd.	7,200	
	Barry Ltd.	1,000	8,200

Working Notes:

1. Value of trade payables taken over by Charlie Ltd. *(₹ '000)*

	Andrew Ltd.	*Barry Ltd.*
Given in balance sheet	13,000	4,600
Less: Statutory liabilities [72 lakhs – 22 lakhs]	(5,000)	(1,000)
Liability to employees	(3,000)	(1,800)
Trade payables	5,000	1,800
80% thereof	4,000	1,440

2. Value of total liabilities taken over by Charlie Ltd. *(₹ '000)*

	Andrew Ltd.		*Barry Ltd.*	
Current liabilities				
Statutory liabilities	7,200		1,000	
Liability to employees	3,000		1,800	
Trade payables (W.N.1)	4,000	14,200	1,440	4,240
Secured loans				
Given in Balance Sheet	16,000		8,000	
Interest waived	-		800	7,200
Value of Inventory (80% of ₹ 184 lakhs)	14,720	1,280		
Unsecured Loans (25% of ₹ 86 lakhs)		2,150		-
		17,630		11,440

3. Assets taken over by Charlie Ltd. *(₹ '000)*

	Andrew Ltd. ₹	*Barry Ltd.* ₹
Fixed Assets	3,400	6,800
Current Assets 80% and 70% respectively of book value	2,880	6,720
	6,280	13,520

4. Goodwill / Capital Reserve on amalgamation *(₹ '000)*

Liabilities taken over (W.N. 2)		17,630	11,440
Equity shares to be issued to Preference Shareholders		200	-
	A	17,830	11,440
Less: Total assets taken over (W.N. 3)	B	(6,280)	(13,520)
	A-B	11,550	(2,080)
		Goodwill	Capital Reserve
Net Goodwill		9,470	

5. Equity shares issued by Charlie Ltd.

			Number
(i)	For Cash		2,00,000
	For consideration other than cash		
(ii)	In Discharge of Liabilities to Employees	4,80,000	
(iii)	To Preference shareholders	20,000	5,00,000
			7,00,000
	Value of shares (₹ 10 x 7,00,000)		₹ 70 lakhs

Question 18

Agni Ltd. and Bayu Ltd. both engaged in similar merchanting activities since 2014, decide to amalgamate their businesses. A holding company, Chandrama Ltd. would be formed on 1st January, 2017 to acquire the entire shares in both the companies.

From the information given below you are required to prepare:

(a) A statement of purchase consideration, supported by requisite working notes.

(b) Balance Sheet of Chandrama Ltd. after the transactions have been completed.

(i) The terms of the offer were:

- *₹ 100, 15 per cent debentures for every ₹ 100 of net assets owned by each company on 31st December, 2016.*
- *₹ 100 equity shares based on two years purchase of profit before taxation. The profit is to be determined by taking weighted average profits of 2015 and 2016, weights being 1 and 2 respectively.*

(ii) It was agreed that the accounts of Bayu Ltd. for the two years ended 31st December, 2016 be adjusted, where necessary, to conform to the accounting policies followed by Agni Ltd.

(iii) The Pre-tax profits, including investment income, of the two companies were as follows:

	2015 ₹	2016 ₹
Agni Ltd.	16,38,000	18,36,000
Bayu Ltd.	17,88,300	25,74,000

(iv) Agni Ltd. values its inventory on FIFO basis while Bayu Ltd. used a different basis. To bring Bayu Ltd.'s values in line with those of Agni Ltd, value of its inventory will require to be reduced by ₹ 36,000 at the end of 2015 and ₹ 1,02,000 at the end of 2016.

(v) Both the companies use straight line method of depreciation.

(vi) Bayu Ltd. deducts 1 per cent from trade receivables every year as a general provision against doubtful debts by ignoring the earlier provisions on it.

(vii) Prepaid expenses in Bayu Ltd. include advertisement expenditure carried forward of ₹ 1,80,000 in 2015 and ₹ 90,000 in 2016, being part of initial advertising in 2015, which is being written off over three years. Similar expenditure in Agni Ltd. has been fully written off in 2015.

(viii) To bring Director's remuneration on to a comparative basis, the profits of Bayu Ltd. are to be reduced by ₹ 1,20,000 in 2015 and ₹ 1,80,000 in 2016 and the net assets are also to be adjusted accordingly.

Summarised Balance Sheets as at 31st December, 2015 and 2016 were as follows:

Agni Ltd.

Liabilities	2015 ₹	2016 ₹	Assets	2015 ₹	2016 ₹
Share capital issued and subscribed:			Fixed assets:		
12,000 shares of ₹ 100 each, fully paid	12,00,000	12,00,000	Furniture and Fixtures: at cost	6,90,000	6,90,000
Reserves and Surplus			Less: depreciation	(69,000)	(1,38,000)
				6,21,000	5,52,000
Capital reserve	-	2,10,000	Investments:		
			Quoted investments at market value	-	7,80,000
Revenue reserve	7,98,300	16,74,000	Current assets:		

Current Liabilities and provisions:			*Inventory at cost*	*18,30,000*	*21,75,000*
Trade payables	*15,02,700*	*18,21,000*	*Trade receivables*	*18,00,000*	*22,20,000*
Provision for taxation	*8,40,000*	*9,60,000*	*Prepaid expenses*	*30,000*	*42,000*
			Cash at bank	*60,000*	*96,000*
	43,41,000	*58,65,000*		*43,41,000*	*58,65,000*

Bayu Ltd.

Liabilities	*2015* ₹	*2016* ₹	*Assets*	*2015* ₹	*2016* ₹
Share capital:			*Fixed assets:*		
Issued and subscribed			*Furniture and fixture at cost*	*9,60,000*	*9,60,000*
15,000 equity shares of ₹ 100 each, fully paid	*15,00,000*	*15,00,000*	*Less: depreciation*	*(1,44,000)*	*(2,88,000)*
Reserves and surplus:				*8,16,000*	*6,72,000*
Revenue reserve	*8,58,000*	*21,42,000*	*Investments:*		
Current liabilities and provisions:			*Quoted investments (Market value ₹ 14,70,000)*	*-*	*12,00,000*
Trade payables	*14,70,000*	*14,82,000*			
Bank overdraft	*-*	*5,10,000*	*Current assets:*		
Provision for taxation	*9,30,000*	*12,90,000*	*Inventory at cost*	*17,91,000*	*22,26,000*
			Trade receivables		
			Less: provision	*17,82,000*	*26,73,000*
			Prepaid expenses	*2,16,000*	*1,44,000*
			Cash at bank	*1,53,000*	*9,000*
	47,58,000	*69,24,000*		*47,58,000*	*69,24,000*

Answer

(a) Statement of Purchase Consideration

	Agni Ltd.			**Bayu Ltd. (Refer W.N. 1)**		
Year	*PBT (₹)*	*Weight*	*₹*	*PBT (₹)*	*Weight*	*₹*
2015	16,38,000	1	16,38,000	15,18,300	1	15,18,300
2016	18,36,000	2	36,72,000	27,63,000	2	55,26,000

Total Profit		53,10,000			70,44,300
Weighted average profit (Divided by 3)		17,70,000			23,48,100
(i)	Two years' purchase of average profits	35,40,000			46,96,200
(ii)	Net assets (Refer working notes 3 and 4)	30,84,000			35,43,000
		66,24,000			82,39,200
(iii)	Discharge of purchase consideration 82,362 Shares will be issued for goodwill amounting ₹ 82,36,200 (₹ 35,40,000 + ₹ 46,96,200) 66,270 15% Debentures will be issued for net assets amounting ₹ 66,27,000 (30,84,000 +35,43,000) Total purchase consideration will amount to ₹ 148,63,200.				

(b) Balance Sheet of Chandrama Ltd. as on 1st January, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Fund**		
Share Capital	1	82,36,200
(2) **Non-Current Liabilities**		
Long-term borrowings	2	66,27,000
Total		1,48,63,200
II. **Assets**		
(1) **Non-current assets**		
Non-current investments	3	1,48,63,200
Total		1,48,63,200

Notes to Accounts

		(₹)	(₹)
1.	Share Capital		
	Issued and subscribed		
	82,362 shares of ₹ 100 each, fully paid up (Issued for consideration other than cash)		82,36,200
2.	Long Term Borrowings		
	Secured Loans		

	66,270 15% Debentures of ₹ 100 each, fully paid		66,27,000
3.	Non-current investments *		
	Shares in Agni Ltd.	66,24,000	
	Shares in Bayu Ltd.	82,39,200	1,48,63,200

* In this case, a holding company, Chandrama Ltd. is being formed on 1st January, 2017 to **acquire the entire shares** in both the companies. Hence, this will appear in the Non-current investments of Chandrama Ltd.

Working Notes:

1. Statement of adjusted Net Profits of Bayu Ltd.

	Year 2015		*Year 2016*	
	₹	₹	₹	₹
Net Profit as given		17,88,300	-	25,74,000
Add: Provision for Bad Debts-W.N.2(a)	18,000		27,000	
Advertising (to the extent written off)	-		90,000	
Depreciation- [W.N.2(b)]	48,000		48,000	
Appreciation in Investment	-		2,70,000	
Value of Opening Inventory	-	66,000	36,000	4,71,000
		18,54,300		30,45,000
Less: Value of Closing Inventory	36,000		1,02,000	
Advertising (to be written off in one year only)	1,80,000		-	
Directors' Remuneration	1,20,000	(3,36,000)	1,80,000	(2,82,000)
		15,18,300		27,63,000

2.

		(₹) *Year 2015*	(₹) *Year 2016*
(a)	Trade receivables as per Balance sheet	17,82,000	26,73,000
	Provision created		
	1% of (₹ 17,82,000 /. 99)	18,000	
	1% of (₹ 26,73,000 / .99)		27,000
(b)	Rate of depreciation under straight line method for Agni Ltd. is (₹ 69,000 / 6,90,000) $\times$100 = 10%. Rate of depreciation under straight line method for Bayu Ltd. is (₹ 1,44,000 / 9,60,000)$\times$ 100= 15% Difference of 5% in depreciation amount i.e. (5% of ₹ 9,60,000 =₹ 48,000) has been added back to ensure uniform accounting policies.		

3 Statement of Net Assets of Agni Ltd.

	₹	₹
Total Assets		58,65,000
Less: Trade payables	18,21,000	
Provision for Taxation	9,60,000	(27,81,000)
		30,84,000

4 Statement of Adjusted Net Assets of Bayu Ltd.

	₹	₹
Furniture and Fixtures	9,60,000	
Less: Depreciation at 10% p.a. for two years	(1,92,000)	7,68,000
Quoted investments at market value		14,70,000
Inventory (₹ 22,26,000 – ₹ 1,02,000)		21,24,000
Trade receivables after Reversal of Provision		
(₹ 26,73,000 + ₹ 27,000)		27,00,000
Prepaid Expenses (₹ 1,44,000 – ₹ 90,000)		54,000
Cash at Bank		9,000
		71,25,000
Less: Trade payables	14,82,000	
Bank Overdraft	5,10,000	
Liability for Directors' Remuneration [1,20,000 + 1,80,000]	3,00,000	
Provision for Taxation	12,90,000	(35,82,000)
		35,43,000

Question 19

Small Ltd. and Little Ltd., two companies in the field of speciality chemicals, decided to go in for a follow on Public Offer after completion of an amalgamation of their businesses. As per agreed terms initially a new company Big Ltd. will be incorporated on 1st January, 2017 with an authorized capital of ₹ 2 crore comprised of 20 lakh equity shares of ₹ 10 each. The holding company would acquire the entire equity shareholding of Small Ltd. & Little Ltd. and in turn would issue its shares to the outside holders of these shares. It is also agreed that the consideration would be a multiple of the average P/E ratio for the period 1st January, 2016 to 31st March, 2016 times the rectified profits of each company, subject to necessary adjustments for complying with the terms of the share issue.

The following information is supplied to you:

	Small Ltd.	Little Ltd.
Ordinary Shares of ₹ 10 each (Nos.)	40 lakhs	20 lakhs
10% Preference shares of ₹ 100 each (Nos.)	2 lakh	Nil
10% Preference shares of ₹ 10 each (Nos.)	Nil	2 lakh
5% debentures of ₹ 10 each (Nos.)	4 lakh	4 lakh
Investments Held		
(a) 4 lakh ordinary shares in Small Ltd.	-	₹ 40 lakhs
(b) 2 lakh ordinary shares in Little Ltd.	₹ 20 lakhs	-
Profit before Interest& Tax (PBIT) after considering impact of Inter-company Transactions and Holdings.	₹ 50 lakhs	₹ 25 lakhs
Average P/E ratio January, 2016 to March, 2016	10	8

The following additional information is also furnished to you in respect of adjustments required to the profit figure as given above:

1. *The profits of the respective companies would be adjusted for half the value of contingent liabilities as on 31st March, 2016.*
2. *Trade receivables of Small Ltd. include an irrecoverable amount of ₹ 2 lakh against which ₹ 1 lakh was recovered but kept in Advance account.*
3. *Little Ltd. had omitted to provide for increased FOREX liability of US$ 10,000 on loan availed in financial year 2015-2016 for purchase of Machinery. The machinery was acquired on 1st January, 2016 and put to use in financial year 2016-2017. The additional liability arose due to change in exchange rates and is arrived at in conformity with prevailing provisions of AS 11. The exchange rate is US $ 1 = INR 50.*
4. *Small Ltd. has omitted to invoice a sale that took place on 31st March, 2016 of goods costing ₹ 2,50,000 at a mark-up of 15 per cent instead the goods were considered as part of closing inventory.*
5. *Closing Inventory of ₹ 45 lakhs of Little Ltd. as on 31st March, 2016 stands undervalued by 10 per cent.*
6. *Contingent liabilities of Small Ltd. and Little Ltd. as on 31st March, 2016 stands at ₹ 5 lakhs and ₹ 10 lakhs respectively.*

The terms of the share issue are as under:

(i) *Shares in Big Ltd. will be issued at a premium of ₹ 13 per share for all external shareholders of Small Ltd. The Premium will be ₹ 15 per share for shares in Big Ltd. issued to all external shareholders of Little Ltd.*

(ii) No shares in Big Ltd. will be issued in lieu of the investments (intercompany holdings) of both companies. Instead the shares so held shall be transferred to Big Ltd. at the close of the financial year ended 31st March, 2017 at Par Value consideration payable on date of transfer.

(iii) Big Ltd. would in addition to the issue of shares to outside shareholders of Small Ltd. and Little Ltd. make a preferential allotment on 31st March, 2017 of 2 lakhs ordinary shares at a premium of ₹ 28 per share to Virgin Capital Ltd. (VCL). These shares will not be eligible for any dividends declared or paid till that date.

(iv) Big Ltd. will go in for a 18 per cent unsecured Bank overdraft facility to meet incorporation costs of ₹ 16 lakhs and towards management expenses till 31st March, 2017 estimated at ₹ 14 lakhs. The overdraft is expected to be availed on 1st February, 2017 and closed on 31st March, 2017 out of the proceeds of the preferential allotment.

(v) It is agreed that interim dividends will be paid on 31.03.2017 for the period January, 2017 to March, 2017 by Big Ltd. at 2 per cent; Small Ltd. at 3 per cent and Little Ltd. at 2.5 per cent. Ignore Dividend Distribution tax.

(vi) The prevailing Income Tax Rate is 25 per cent.

You are required to compute the number of shares to be issued to the shareholders of each of the companies and prepare the projected Profit and Loss Account for the period from 1st January, 2017 to 31.03.2017 of Big Ltd. and its Balance Sheet as on 31st March, 2017.

Answer

Computation of number of shares issued

Calculation of Rectified Profits and Purchase consideration

	₹	₹
Small Ltd.		
Given profits		50,00,000
Less: Irrecoverable Trade receivables	1,00,000	
50% Contingent Liability	2,50,000	(3,50,000)
		46,50,000
Add: Profit on omitted sale (15% of ₹ 2,50,000)		37,500
		46,87,500
Less: Debenture interest (4,00,000 x₹ 10 x 5 %)		(2,00,000)
		44,87,500
Less: Income Tax @ 25%		(11,21,875)
Profits after Tax (PAT)		33,65,625
Less: Preference Dividend (10% of ₹ 2,00,00,000)		(20,00,000)
Rectified Profits		13,65,625

Average PE ratio = 10			
Total consideration for all equity shareholders (Average PE ratio × Profit)			1,36,56,250
*Less:*10% thereof for shareholders of Little Ltd. [As Little Ltd. holds 4 lakhs out of 40 lakhs shares of Small Ltd.]			(13,65,625)
Balance available for other shareholders of Small Ltd.	[A]		1,22,90,625
Little Ltd.			
Given profits			25,00,000
Less: Increase in FOREX liability (US$10,000 × 50) *		5,00,000	
50% Contingent Liability		5,00,000	(10,00,000)
			15,00,000
Add: Undervaluation of inventory (45,00,000×10/90)			5,00,000
			20,00,000
Less: Debenture interest (4,00,000 × ₹ 10 × 5 %)			(2,00,000)
			18,00,000
Less: Income Tax @ 25%			(4,50,000)
Profits after Tax (PAT)			13,50,000
Less: Preference Dividend (10% of ₹ 20,00,000)			(2,00,000)
Rectified Profits			11,50,000
Average PE ratio = 8			
Total consideration for all equity shareholders (Average PE ratio × Profit)			92,00,000
Less:10% thereof for shareholders of Small Ltd. [As Small Ltd. holds 2 lakhs out of 20 lakhs shares of Little Ltd.]			(9,20,000)
Balance available for other shareholders of Little Ltd.	[B]		82,80,000

Statement showing Disposal of Purchase Consideration

	Small Ltd. ₹	*Little Ltd.* ₹	*Total* ₹
Purchase Consideration	1,22,90,625 [A] above	82,80,000 [B] above	2,05,70,625
Number of shares [Purchase consideration/(Face Value + Securities Premium)]	5,34,375	3,31,200	8,65,575
Share Capital	53,43,750	33,12,000	86,55,750

Securities Premium	69,46,875	49,68,000	1,19,14,875
Purchase Consideration	1,22,90,625	82,80,000	2,05,70,625

* As per para 46 and 46A of AS 11 as per the Companies (Accounting Standards) Rules, 2006, the Companies have the option to treat the exchange difference on long-term foreign currency monetary items i.e. they can be added to or deducted from the cost of the asset. It is assumed, that this option has not been exercised, hence the exchange difference been taken to profit and loss. Other alternative is also possible.

Projected Profit and Loss Account of Big Ltd.
for the period 1st January, 2017 to 31st March, 2017

		Note No.	₹
I.	Revenue from operations		—
II.	Other income	5	17,00,000
III.	Total Revenue(I+II)		17,00,000
IV.	Expenses:		
	Employee benefits expense	7	14,00,000
	Finance costs	6	90,000
	Other expenses	8	16,00,000
V.	Total expenses		30,90,000
VI.	Loss for the period (V - III)		(13,90,000)

Projected Balance Sheet of Big Ltd.
as on 31st March, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	1,06,55,750
(b) Reserves and Surplus	2	1,59,51,760
Total		2,66,07,510
II. **Assets**		
(1) **Non-current assets**		
Non-current investments	3	2,65,70,625
(2) **Current assets**		
Cash and cash equivalents	4	36,885
Total		2,66,07,510

Notes to Accounts

		(₹)	(₹)
1.	Share Capital		
	Authorised		
	20 lakhs shares of ₹ 10 each	2,00,00,000	
	Issued & Paid up		
	10,65,575 shares of ₹ 10 each (out of the above 8,65,575 shares have been issued for consideration other than cash)	1,06,55,750	1,06,55,750
2.	Reserves and surplus		
	Securities Premium (₹ 1,19,14,875 + 56,00,000)		1,75,14,875
	Loss for the period	(13,90,000)	
	Less: Dividend (2% of ₹ 86,55,750)	(1,73,115)	(15,63,115)
	Balance of Profit and Loss Account carried forward		1,59,51,760
3.	Non-current investments		
	Shares in Subsidiaries (W.N. 4)		2,65,70,625
4.	Cash and cash equivalents		
	Cash at Bank (W.N. 3)		36,885
5.	Other income		
	Dividends received from Subsidiaries (₹ 12,00,000 + 5,00,000)		17,00,000
6.	Finance costs		
	Interest on Bank O/D		90,000
7.	Employee benefits expenses		
	Management expenses		14,00,000
8.	Other expenses		
	Preliminary expenses*		16,00,000

*As per para 56 of AS 26, 'Intangible Assets', preliminary expenses are to be recognized as expenses as and when they are incurred.

Working Notes:

1. **Shares issued by Big Ltd. to Virgin capital Ltd. (VCL)**

Number of shares issued	2,00,000
Face Value of Share Capital @ ₹ 10 each	₹ 20,00,000
Securities Premium @ ₹ 28 each	₹ 56,00,000
Total cash received from VCL	₹ 76,00,000

2. **Overdraft of Big Ltd. as on 31.3.2017**

	₹
Towards Incorporation expenses i.e. preliminary expenses	16,00,000
Towards Management expenses	14,00,000
Total Bank Overdraft availed	30,00,000
Interest @ 18% p.a. for 2 months	90,000

3. **Bank balance of Big Ltd. as on 31.3.2017**

Bank Account of Big Ltd.

		₹			₹
01.02.2017	To Overdraft	30,00,000	01.02.2017	By Incorporation expenses	16,00,000
31.03.2017	To VCL	76,00,000	31.03.2017	By Management expenses	14,00,000
31.03.2017	To Dividend		31.03.2017	By Interest on Overdraft	90,000
	Small	12,00,000*			
	Little	5,00,000†	31.03.2017	By Overdraft	30,00,000
			31.03.2017	By Dividend paid	1,73,115‡
			31.03.2017	By Shares in Small Ltd. bought from Little Ltd.	40,00,000
			31.03.2017	By Shares in Little Ltd. bought from Small Ltd.	20,00,000
				By Balance c/d (Bal. fig.)	36,885
		1,23,00,000			1,23,00,000

*(40,00,000 x 10) x 3% = 12,00,000.

† (20,00,000 x 10) x 2.5% = 5,00,000.

‡ [(5,34,375 + 3,31,200) x 10] x 2% = 1,73,115.

4. Investments of Big Ltd. in Projected Balance Sheet

	₹
Purchase consideration paid for acquiring shares of outside holders of-	
Small Ltd	1,22,90,625
Little Ltd.	82,80,000
Consideration paid in cash for acquiring cross holdings	
From Small Ltd. (shares of Little Ltd.)	20,00,000
From Little Ltd. (shares of Small Ltd.)	40,00,000
	2,65,70,625

Question 20

Dawn Ltd. was incorporated to take over Arun Ltd., Brown Ltd. and Crown Ltd. Summarised Balance Sheets of all the three companies as on 31.03.2017 are as follows:

(₹ '000)

Particulars	*Arun Ltd.*	*Brown Ltd.*	*Crown Ltd.*
Liabilities:			
Equity Share Capital (Share of ₹ 10 each)	*1,800*	*2,100*	*900*
Reserves	*300*	*150*	*300*
10% Debentures	*600*	*---*	*300*
Other Liabilities	*600*	*450*	*300*
Total	*3,300*	*2,700*	*1,800*

(₹ '000)

Particulars	*Arun Ltd.*	*Brown Ltd.*	*Crown Ltd.*
Assets:			
Net Tangible Block	*2,400*	*1,800*	*1,500*
Goodwill	*-*	*150*	*-*
Other Assets	*900*	*750*	*300*
Total	*3,300*	*2,700*	*1,800*

From the following information you are to:

(a) Work out the number of Equity shares and Debentures to be issued to the shareholders of each company.

(b) Prepare the Balance Sheet of Dawn Ltd. as on 31.03.2017.

Information:

(i) *Assets are to be revalued and the revalued amount of Tangible Block and other Assets are as follows:*

	Tangible Block	*Other Assets*
Arun Ltd.	*₹ 30,00,000*	*₹ 10,50,000*
Brown Ltd.	*₹ 15,00,000*	*₹ 4,20,000*
Crown Ltd.	*₹ 18,00,000*	*₹ 2,40,000*

(ii) *Normal profit on capital employed is to be taken at 10%*

(iii) *Average amount of profit for three years before charging interest on Debentures are:*

Arun Ltd.	*₹ 5,40,000*
Brown Ltd.	*₹ 4,32,000*
Crown Ltd.	*₹ 3,12,000*

(iv) *Goodwill is to be calculated at three years' purchase of average super profits for three years, such average is to be calculated after adjustment of 10% depreciation on Increase/Decrease on revaluation of Fixed Assets (Tangible Block).*

(v) *Capital employed being considered on the basis of revaluation of Tangible Assets and other assets.*

(vi) *Equity Shares of ₹ 10 each fully paid up in Dawn Ltd. are to be distributed in the ratio of average profit after adjustment of depreciation on revaluation of Tangible Block.*

(vii) *10% Debentures of ₹ 100 each fully paid up are to be issued by Dawn Ltd. for the balance due.*

(viii) *The ratio of issue of Equity shares and debentures of Dawn Ltd. are to be maintained at 3:1, towards the takeover companies.*

(ix) *The amount required for preliminary expenses of ₹ 1,50,000 and for payment to existing Debenture holders, were provided by issuing Equity shares of ₹ 10 each in Dawn Ltd.*

Answer

(a) Number of Equity shares and Debentures to be issued to the shareholders of each company

Total Purchase Consideration (WN 2) ₹ 74,34,000

As per point (viii) in the question, ratio of equity shares and debentures to be issued/maintained by Dawn Ltd. is 3:1. Therefore,

Total Equity to be issued = 74,34,000/4 x 3 = ₹ 55,75,500

Total Debentures to be issued = 74,34,000/4 = ₹ 18,58,500

	Arun Ltd. ₹	*Brown Ltd.* ₹	*Crown Ltd.* ₹	*Total paid by Dawn Ltd. in 3:1* ₹
Equity shares of ₹ 10 each in the ratio of adjusted profits (420:462:252)	20,65,000	22,71,500	12,39,000	55,75,500
10% Debentures [Balance of purchase consideration] – Refer W.N. 2	11,90,000	1,43,500	5,25,000	18,58,500
	32,55,000	24,15,000	17,64,000	74,34,000
No. of shares of ₹ 10 each	2,06,500	2,27,150	1,23,900	5,57,550
10% Debentures of ₹ 100 each in numbers	11,900	1,435	5,250	18,585

(b) Balance Sheet of Dawn Ltd. as at 31.3.2017

Particulars	*Note No.*	₹
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	66,25,500
(b) Reserves and Surplus	2	(1,50,000)
(2) **Non-Current Liabilities**		
Long-term borrowings	3	18,58,500
(3) **Current Liabilities** (600 + 450 + 300)		13,50,000
Total		96,84,000
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
(a) Tangible assets (30 + 15 + 18)**		63,00,000
(b) Intangible assets	4	16,74,000
(2) **Current assets** (10.5 + 4.2 + 2.4)		17,10,000
Total		96,84,000

Notes to Accounts

		(₹)
1.	Share Capital	
	Equity share capital (W.N.3)	
	6,62,550 shares of ₹ 10 each, fully paid up (All shares issued for consideration other than cash)	66,25,500
2.	Reserves & Surplus	
	Profit or loss A/c (Loss)*	(1,50,000)
3.	Long Term Borrowings	
	Secured	
	18,585,10% Debentures of₹ 100 each	18,58,500
4.	Intangible assets	
	Goodwill (W.N.1)	16,74,000

* As per para 56 of AS 26 "Intangible Assets", preliminary expenses are to be recognized as expenses as and when they are incurred. As per Schedule III*, debit balance of statement of profit and loss shall be shown as a negative figure under the head 'Surplus'.

** It is assumed that tangible assets have been taken over at the revalued amount and the depreciation impact of the same is only considered for the goodwill and capital employed calculation.

Working Notes:

1. **Computation of Goodwill**

	Arun Ltd. ₹	*Brown Ltd.* ₹	*Crown Ltd.* ₹	*Total* ₹
Profit	5,40,000	4,32,000	3,12,000	12,84,000
Debenture Interest	(60,000)	-	(30,000)	(90,000)
Profit after Debenture Interest	4,80,000	4,32,000	2,82,000	11,94,000
Adjustment for increase/decrease in depreciation due to revaluation (WN 4)	(60,000)	30,000	(30,000)	(60,000)
Adjusted Profit	4,20,000	4,62,000	2,52,000	11,34,000
Less: Normal Profit @ 10% on Capital employed as per Working				

*Erstwhile Schedule VI to the Companies Act, 1956.

Note 2 – Calculation [A]	(2,85,000)	(1,47,000)	(1,44,000)	(5,76,000)
Super Profits	1,35,000	3,15,000	1,08,000	5,58,000
Goodwill on 3 years of super profits	4,05,000	9,45,000	3,24,000	16,74,000

2. Statement showing calculation of Capital Employed and Purchase Consideration

	Arun Ltd. ₹	*Brown Ltd.* ₹	*Crown Ltd.* ₹	*Total* ₹
Fixed Assets	30,00,000	15,00,000	18,00,000	63,00,000
Current Assets	10,50,000	4,20,000	2,40,000	17,10,000
	40,50,000	19,20,000	20,40,000	80,10,000
Less: Debentures	(6,00,000)	---	(3,00,000)	(9,00,000)
Current Liabilities	(6,00,000)	(4,50,000)	(3,00,000)	(13,50,000)
Capital Employed [A]	28,50,000	14,70,000	14,40,000	57,60,000
Goodwill as per W.N.1	4,05,000	9,45,000	3,24,000	16,74,000
Purchase consideration	32,55,000	24,15,000	17,64,000	74,34,000

3. Total number of equity shares issued

Equity Shares	₹
For purchase consideration	5,57,550
Preliminary expenses (₹ 1,50,000/ ₹ 10)	15,000
Payment of existing debenture holders (₹ 6,00,000 + ₹ 3,00,000) / ₹ 10	90,000
	6,62,550

4. Adjustment for increase/decrease in depreciation due to revaluation

	Arun Ltd.	Brown Ltd.	Crown Ltd.
	`	`	`
Revalued Tangible Block	30,00,000	15,00,000	18,00,000
Less : Net Tangible Block as per BS	24,00,000	18,00,000	15,00,000
Increase/(Decrease) in tangible block	6,00,000	(3,00,000)	3,00,000
Increase/(Decrease) in depreciation @ 10%	60,000	(30,000)	30,000

Question 21

The following are the summarized Balance Sheets of H Ltd. and S Ltd. as at 31.03.15:

	H Ltd. (₹)	S Ltd. (₹)		₹ in lakhs H Ltd. (₹)	S Ltd. (₹)
Share capital			Fixed assets	60	18
Share of ₹ 10 each	50	10	Investment in S Ltd. (60,000 shares)	6	-
General reserve	50	20	Trade receivables	35	5
Profit and Loss	20	15	Inventories	30	25
Secured loan	20	3	Cash at Bank	39	2
Current liabilities	30	2		—	—
	170	50		170	50

H Ltd. holds 60% of the paid up capital of S Ltd. and balance is held by a foreign company. The foreign company agreed with H Ltd. as under:

(i) The shares held by the foreign company will be sold to H Ltd. at ₹ 50 above than nominal value of per share.

(ii) The actual cost per share to the Foreign Company was ₹ 11, gain accruing to Foreign Company is taxable @ 20%. The tax payable will be deducted from the sale proceeds and paid to Government by H Ltd. 50% of the consideration (after payment of tax) will be remitted to Foreign Company by H Ltd. and also any cash for fractional shares allotted.

(iii) For the Balance of consideration H Ltd. would issue its shares at their intrinsic value.

It was also decided that H Ltd. would also absorb S Ltd. simultaneously by writing down the fixed assets of S Ltd. by 10%. The Balance Sheet figure included a sum of ₹ 1 lakh due by S Ltd. to H Ltd, included inventory of ₹ 1.5 lakhs purchased from S Ltd. who sold them at cost plus 20%.

Pass Journal entries in the books of H Ltd. to record the above arrangement on 31.03.15. Also prepare Balance Sheet of H Ltd. after absorption. Workings should form part of your answer

Answer

Journal Entries in the books of H Ltd.

			₹	₹
1.	Business Purchase A/c	Dr.	24,00,000	
	To Foreign Company (W.N.1)			24,00,000
	(Being business purchased)			

2.	Foreign Company	Dr.	24,00,000	
	To Tax Payable A/c			3,92,000
	To Bank A/c(₹ 10,04,000 + ₹ 20)			10,04,020*
	To Equity Share Capital A/c			3,34,660
	To Securities Premium A/c			6,69,320
	(Being payment made to foreign company)			
3.	Fixed Assets A/c [18,00,000 – 10%]	Dr.	16,20,000	
	Trade receivables A/c	Dr.	5,00,000	
	Inventories A/c	Dr.	25,00,000	
	Cash at Bank A/c	Dr.	2,00,000	
	To Current Liabilities A/c			2,00,000
	To Secured Loan A/c			3,00,000
	To Investment in S Ltd. A/c			6,00,000
	To Business Purchase A/c			24,00,000
	To Capital Reserve A/c (B.F.)			13,20,000
	(Being various assets and liabilities taken over)			
4.	Profit and Loss A/c	Dr.	25,000	
	To Inventories A/c			25,000
	(Being elimination of unrealized profit i.e. $\frac{1,50,000}{(100+20)} \times 20 =$ ₹ 25,000)			
5.	Current Liabilities A/c	Dr.	1,00,000	
	To Trade receivables A/c			1,00,000
	(Being elimination of mutual owing)			
6.	Tax Payable A/c	Dr.	3,92,000	
	To Bank A/c			3,92,000
	(Being tax paid to Government)			

* It is assumed that payment of fractional shares has also been routed through Bank A/c along with 50% payment remitted to Foreign Company.

Balance Sheet of H Ltd. (After Absorption)

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	53,34,660
(b) Reserves and Surplus	2	89,64,320
(2) **Non-Current Liabilities**		
Long-term borrowings	3	23,00,000
(3) **Current Liabilities**₹ (30,00,000 + 2,00,000–1,00,000)		31,00,000
Total		1,96,98,980
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets	4	76,20,000
(2) **Current assets**		
(a) Inventories (₹ 30,00,000-₹ 25,000+₹ 25,00,000)		54,75,000
(b) Trade receivables (₹ 35,00,000 –₹ 1,00,000 +₹ 5,00,000)		39,00,000
(c) Cash and cash equivalents	5	27,03,980
Total		1,96,98,980

Notes to Accounts

		(₹)	*(₹)*
1.	Share Capital		
	5,33,466 Shares of ₹ 10 each (out of above, 33,466 shares issued for consideration other than cash)		53,34,660
2.	Reserves and surplus		
	General Reserve	50,00,000	
	Profit & Loss (₹ 20,00,000 – ₹ 25,000)	19,75,000	
	Capital Reserve	13,20,000	
	Securities Premium	6,69,320	89,64,320
3.	Long Term Borrowings		
	Secured Loan (₹ 20,00,000+₹ 3,00,000)		23,00,000

4.	Tangible Assets		
	Fixed Assets (₹ 60,00,000+ ₹ 16,20,000)		76,20,000
5.	Cash and cash equivalents		
	Cash at Bank (₹ 39,00,000 + ₹ 2,00,000 – ₹ 10,04,020 – ₹ 3,92,000)		27,03,980

Working Notes:

1. Amount payable to foreign company & Capital Gain of Foreign Company

Price per share of S Ltd.=₹ 50 + ₹ 10 (Nominal value) = ₹ 60

Value of 40% shares held by foreign company = 10,00,000 x 40% x $\frac{60}{10}$ = ₹ 24,00,000

Capital gain = ₹ 24,00,000 – $\left(4,00,000 \times \frac{11}{10}\right)$ = ₹ 19,60,000

Tax on capital gain = ₹ 19,60,000 × 20% = ₹ 3,92,000

Amount payable to Foreign Company after tax = ₹ 24,00,000 – ₹ 3,92,000

= ₹ 20,08,000

50% of ₹ 20,08,000 = ₹ 10,04,000 to be remitted to foreign company.

2. Intrinsic value of shares of H Ltd. and balance payment to foreign company

	₹	₹
Total assets (Excluding Investment in S Ltd.)		1,64,00,000
Add: Investment in S Ltd. (60,000 shares × ₹ 60) (Since they have been purchased from Foreign Co.)		36,00,000
		2,00,00,000
Less: Liabilities:		
Secured Loan	20,00,000	
Current Liability	30,00,000	(50,00,000)
Net Assets		1,50,00,000
No. of equity shares		5,00,000
Intrinsic value per share		₹ 30

Number of shares to be issued for payment of 50% balance amount $\frac{₹\,10,04,000}{30} = 33,466$ shares

Cash for fractional shares = ₹ 10,04,000 – (33,466 x ₹ 30) = ₹ 20

Question 22

The following are the summarized Balance Sheets of Cat Ltd. and Bat Ltd. as on 31.3.2017:

Liabilities	(₹ in thousands)	
	Cat Ltd.	Bat Ltd.
Share capital:		
Equity shares of 100 each fully paid up	2,000	1,000
Reserves	800	---
10% Debentures	500	---
Loans from Banks	250	450
Bank overdrafts	---	50
Trade payables	300	300
Dividend payable	200	---
Total	4,050	1,800
Assets		
Tangible assets/fixed assets	2,700	850
Investments (including investments in Bat Ltd.)	700	---
Trade receivables	400	150
Cash at bank	250	---
Accumulated loss	---	800
Total	4,050	1,800

Bat Ltd. has acquired the business of Cat Ltd. The following scheme of merger was approved:

(i) Banks agreed to waive off the loan of ₹ 60 thousands of Bat Ltd.

(ii) Bat Ltd. will reduce its shares to ₹ 10 per share and then consolidate 10 such shares into one share of ₹ 100 each (new share).

(iii) Shareholders of Cat Ltd. will be given one share (new) of Bat Ltd. in exchange of every share held in Cat Ltd.

(iv) Dividend of Cat Ltd. will be paid after merger to shareholders of Cat Ltd.

(v) Trade payables of Bat Ltd. includes ₹ 100 thousands payable to Cat Ltd.

(vi) Cat Ltd. will cancel 20% holding in Bat Ltd. as investment, which was held at a cost of ₹ 250 thousands.

Pass necessary entries in the books of Bat Ltd. and prepare Balance Sheet after merger.

Answer

Journal Entries in the books of Bat Ltd.

Date			*(₹ in thousands)*	
2017			*Dr.*	*Cr.*
March,31	Loan from bank A/c	Dr.	60	
	To Reconstruction A/c			60
	(Being loan from bank waived off to the extent of ₹ 60 thousand)			
	Equity share capital A/c (₹ 100)	Dr.	1,000	
	To Equity share capital A/c (₹ 10)			100
	To Reconstruction A/c			900
	(Being Equity share of ₹ 100 each reduced to ₹ 10 each)			
	Equity share capital A/c (₹ 10)	Dr.	100	
	To Equity share capital A/c (₹ 100 each)			100
	(Being 10 Equity shares of ₹ 10 each consolidated to one share of ₹ 100 each)			
	Reconstruction A/c	Dr.	960	
	To Profit and loss A/c			800
	To Capital reserve A/c			160
	(Being accumulated losses set off against reconstruction A/c and balance transferred to capital reserve account)			
	Business purchase A/c	Dr.	1,980	
	To Liquidator of Cat Ltd.			1,980
	(Being purchase of business of Cat Ltd.)			
	Fixed asset A/c	Dr.	2,700	
	Investment A/c ₹ (700 – 250)	Dr.	450	
	Trade receivables A/c	Dr.	400	
	Cash at bank A/c	Dr.	250	
	To Trade payables A/c			300
	To Dividend A/c			200
	To Loans from bank A/c			250

	To 10% Debenture A/c		500
	To Business purchase A/c		1,980
	To Reserves A/c [W.N.2]		570
	(Being assets, liabilities and reserves taken over under pooling of interest method)		
	Liquidator of Cat Ltd. A/c Dr.	1,980	
	To Equity share capital A/c		1,980
	(Being payment made to liquidators of Cat Ltd. by allotment of 19,800 new equity shares)		
	Trade payables A/c Dr.	100	
	To Trade receivables A/c		100
	(Being mutual owing cancelled)		
	Dividend A/c Dr.	200	
	To Bank A/c		200
	(Being dividend paid off)		

Balance Sheet of Bat Ltd. (and reduced) after merger as on 31.3.2017

Particulars	*Note No.*	*(₹ in thousands)*
I. Equity and Liabilities		
(1) **Shareholder's Funds**		
(a) Share Capital	1	2,080
(b) Reserves and Surplus	2	730
(2) **Non-Current Liabilities**		
Long-term borrowings	3	1,140
(3) **Current Liabilities**		
(a) Trade Payables (300 + 300 – 100)		500
(b) Short-term borrowings	4	50
Total		4,500
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets (2,700 + 850)		3,550
(b) Non-current investments (700 – 250)		450
(2) **Current assets**		
(a) Trade receivables (400 + 150 – 100)		450
(b) Cash and cash equivalents	5	50
Total		4,500

Notes to Accounts

		(₹ in thousands)	(₹ in thousands)
1.	Share Capital		
	20,800 Equity shares of 100 each fully paid		
	Out of the above, 19,800 shares have been issued		
	for consideration other than cash)		2,080
2.	Reserves and Surplus		
	Capital reserve	160	
	General reserve	570	730
3.	Long Term Borrowings		
	Secured		
	10% Debentures	500	
	Loan from bank (₹ 250 + ₹ 450 – ₹ 60)	640	1,140
4.	Short-term Borrowings		
	Bank overdraft		50
5.	Cash and cash equivalents		
	Cash at Bank (₹ 250 – ₹ 200)		50

Working Notes:

1. Calculation of purchase consideration

	Shares
One share of Bat Ltd. will be issued in exchange of every share of Cat Ltd. (i.e. 20,000 equity shares of Bat Ltd will be issued against 20,000 equity shares of Cat Ltd.)	20,000
Less: Shares already held (20% of 10,000)	
2,000 shares converted in new equity shares	(200)
Number of shares to be issued by Bat Ltd to shareholders of Cat Ltd.	19,800

2. Calculation of Reserve as per AS 14

Reserves as on 31.03.2017 of CAT Ltd.	₹ 800 thousands
Less: Cancellation of investment in BAT Ltd.	₹ 250 thousands
Balance of reserve on the amalgamation date	₹ 550 thousands

As per Para 35 of AS 14, the difference between the amount recorded as share capital issued (plus any additional consideration in the form of cash or other assets) and the amount of share capital of the transferor company should be adjusted in reserves (of the transferee company – as explained in Para 16 of AS 14)

Amount recorded as share capital issued by BAT Ltd	₹ 1,980 thousands
Amount of share capital of CAT Ltd.	₹ 2,000 thousands
Net adjustment to the reserves of BAT Ltd	₹ 20 thousands

"Hence, net credit to reserves at the time of taking over of assets and liabilities will be ₹ 550 thousands + ₹ 20 thousands = ₹ 570 thousands".

Question 23

A Ltd., agreed to absorb B Ltd., on 31st March 2017, whose summarized Balance Sheet stood as follows:

Liabilities	₹	Assets	₹
Share Capital:		Fixed Assets	7,00,000
80,000 Equity shares of		Investments	-
₹ 10 each fully paid up	8,00,000	Current Assets,	
Reserves & Surplus:		Loans and Advances:	
General Reserve	1,00,000	Inventory-in-trade	1,00,000
Current Liabilities and		Trade receivables	2,00,000
Provisions :			
Trade payables	1,00,000		
	10,00,000		10,00,000

The consideration was agreed to be paid as follows:

(a) A payment in cash of ₹ 5 per share in B Ltd., and

(b) The issue of shares of ₹ 10 each in A Ltd. on the basis of 2 equity shares (valued at ₹ 15) and one 10% Cumulative Preference shares (valued at ₹ 10) for every five shares held in B Ltd.

The whole of the share capital consists of shareholdings in exact multiple of five except the followings holdings:

A	116
B	76
C	72
D	28
Other individual	8 (each member holding one share each)
	300

It was agreed that A Ltd. will pay in cash for fractional shares equivalent at agreed value of shares in B Ltd., i.e.₹ 65 for five shares of ₹ 50 paid.

Prepare a statement showing the purchase consideration receivable in shares and cash.

Answer

Purchase Consideration

	₹
31,994 Equity shares @ ₹ 15 each	4,79,910
15,997 Preference shares @ ₹ 10 each	1,59,970
Cash on 79,985 shares (i.e 80,000 – 15) of B Ltd.@ ₹ 5 each	3,99,925
	10,39,805
Add: Cash for fractional shares (W.N. 3)	195
	10,40,000

Working Notes:

1. Schedule showing fractional shares

Holding of Shares		*Exchangeable in multiple of five*	*Exchange in Equity shares*	*Exchange in preference shares*	*Non exchangeable shares*
A	116	115	46	23	1
B	76	75	30	15	1
C	72	70	28	14	2
D	28	25	10	5	3
Others	8	-	-	-	8
	300	285	114	57	15

2. Shares Exchangeable: Equity Shares in A Ltd.

	No. of shares		No. of shares
(i) 80,000 – 300	79,700	2/5 thereof	31,880
(ii) 300 – 15	285	2/5 thereof	114
	79,985		31,994

Shares Exchangeable: Preference Shares in A Ltd.

	No. of shares		No. of shares
(i) 80,000 – 300	79,700	1/5 thereof	15,940
(ii) 300 – 15	285	1/5 thereof	57
	79,985		15,997

3. There are 15 shares (W.N.1) in B Ltd. which are not capable of exchange into equity and preference shares of A Ltd. They will be paid cash = $15 \times 10 \times \frac{65}{50} = 195$.

Question 24

As part of its expansion strategy White Ltd. has decided to amalgamate its business with that of Black Ltd. and new company Black & White Ltd. being incorporated on the 1st September 2016 having an authorized equity capital of 2 crore shares of ₹ 10 each. Black & White Ltd. shall in turn acquire the entire equity shares of White Ltd. and Black Ltd. in consideration for issuing its equity at 25% premium on 1st October, 2016. It is also agreed that the consideration shall be based on the product of the profits available to equity shareholders of each entity, times it PE multiple. The preference shareholders & debenture holders are to be satisfied by the issue of similar instruments in Black & White Ltd. on 1-10-2016 in lieu of their existing holdings. Accordingly, the relevant information is supplied to you as under:

	White Ltd.	*Black Ltd.*
Paid up Equity shares of ₹ 10 class (Nos)	*3 Lakhs*	*1.2 Lakhs*
8% Preference Shares ₹ 10 paid (Nos)		*1 Lakh*
5% Redeemable Debentures 2017 of ₹ 10 each (Nos)		*0.8 Lakh*
Profits before Interest & Taxation (₹)	*6,00,000*	*4,40,000*
Price to Earnings Multiple	*15*	*10*

To augment the Cash retention level of Black & White Ltd. it is decided that on 1st October, 2016 Black & White Ltd. shall collect full share application money for the issue 20,00,000 equity shares @40% premium under Private Placement. The allotment of the shares will be made on 31-12-2016 and such shares shall qualify for dividend from 2017 only.

Black & White Ltd. also shall avail a 12.50% TOD of 15 lakhs to meet its preliminary expenses and cost of working which amount to ₹ 12 lakhs and ₹ 2 lakhs respectively. The TOD will be availed on 1st November, 2016 and closed on 31st December, 2016. Preliminary expenditure is tax deductible @ 20% each year.

Due to an accounting omission the opening inventory of Black Ltd. of 5 lakh (actual value) & the closing inventory of White Ltd. of 2.20 lakh was understated & overstated by 5% and 10% respectively.

The dividend schedule proposed is that all companies would pay interim dividend for equity, for the period from 1st October, 2016 to 31st December, 2016. The rates of dividend being White Ltd. @ 5%, Black Ltd. @ 2% and Black & White Ltd. @ 3.5%. The preference shareholders & debenture holders dues for the post take over period are discharged on 31.12.2016.

It is proposed that in the period October-December 2016, Black & White Ltd. would carry out trade in futures that would generate an absolute post tax return of 18% by using the funds *generated from the Private Placement. The trades would be squared off on 31.12.2016. Proceeds from such transactions are not liable to withholding taxes.*

You are required to prepare a projected Profit & Loss A/c for the period ended 31st December, 2016 and a Balance Sheet on that date for Black & White Ltd.

The corporation tax rate for the company is 40%.

Answer

Projected Profit & Loss Account of Black & White Ltd. for the period ended 31-12-2016

		Note No.	₹
I.	Revenue from operations		—
II.	Other income	6	85,74,000
III.	Total Revenue (I+II)		85,74,000
IV.	Expenses:		
	Finance costs	7	41,250
	Other expenses	8	2,00,000
V.	Total expenses		2,41,250
VI.	Profit before tax (III - V)		83,32,750
VII	Tax expense:		
	Current tax	9	32,63,500
VIII	Profit for the period (VI-VII)		50,69,250

Projected Balance Sheet of Black & White Ltd. as at 31-12-2016

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	2,63,36,000
(b) Reserves and Surplus	2	1,29,96,490
(2) **Non-Current Liabilities**		
Long-term borrowings	3	8,00,000
(3) **Current Liabilities**		
Short-term provisions	4	32,63,500
Total		4,33,95,990

II.	**Assets**		
	(1) **Non-current assets**		
	Non-current investments	5	84,70,000
	(2) **Current assets**		
	Cash and cash equivalents		3,49,25,990
	Total		4,33,95,990

Notes to Accounts

		₹	₹
1.	Share Capital		
	Authorised share capital 2 crore Equity shares of ₹ 10 each	20,00,00,000	
	Issued, subscribed & paid up		
	25,33,600 Shares of ₹ 10 each		
	(of the above 5,33,600 shares issued for consideration other than cash)	2,53,36,000	
	Preference Shares		
	1 lakh 8% Preference Shares ₹ 10 paid	10,00,000	2,63,36,000
2.	Reserves and Surplus		
	Securities Premium Account (93,34,000 – 12,00,000)	81,34,000	
	Profit & Loss Account	50,69,250	
	Less: Appropriation		
	Dividends (Equity & Preference)	(2,06,760)	1,29,96,490
3.	Long-term borrowings		
	Secured loan		
	5% Red. Debentures 2017 of ₹ 10 each		8,00,000
4.	Short-term provisions		
	Provision for taxation		32,63,500
5.	Non-current investments		
	Investments in Subsidiaries		
	In Equity shares at cost	66,70,000	
	In preference shares at cost	10,00,000	84,70,000
	5% Red. Deb 2017 of ₹ 10	8,00,000	

6.	Other income		
	Dividends received from Subsidiaries	1,74,000	
	Profits from Futures Trading	84,00,000	85,74,000
7.	Finance costs		
	Interest on TOD	31,250	
	Debenture interest	10,000	41,250
8.	Other expenses		
	Working capital expenses		2,00,000
9.	Current tax		
	Provision for tax @ 40% on pre-tax profit - ₹ 81,58,750		32,63,500

Note:

1. Dividend received is exempted income and is not subject to tax in the hands of recipient. It is assumed that rate of dividend given in the question is net of tax.
2. Dividend distributed by Black and White Ltd. is subject to dividend distribution tax, if not net of tax.
3. As per the Companies Act, 2013, the balance of securities premium account can be used for writing off the preliminary expenses. As the company is having sufficient balance in the securities premium account, the amount of preliminary expenses is adjusted from the balance of securities premium account. As per para 56 of AS 26, when an 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 recognized, then such an expenditure is recognized as an expense when it is incurred. However, whenever there is conflict in the treatment of a particular item as per Law / Statue & Accounting Standards then the Law / Statue will prevail. Accordingly, the above question has been solved by setting off the preliminary expenses from Securities Premium A/c. In this case it will be treated as permanent difference. Hence no DTA/DTL will be created.
4. Alternatively, one may follow the treatment prescribed by AS 26 and expense out the preliminary expenses in the year it is incurred. In that case Deferred tax asset will be created due to the temporary difference arising on account of the difference in the treatment of preliminary expense in the books of accounts and as per the Income tax Act, 1961.

Working Notes:

1. Calculation of Rectified Profits

	White Ltd. (₹)	*Black Ltd. (₹)*
Value of inventory as given	2,20,000 (Overstated)	5,00,000 (Actual)

Adjustment therein due to incorrect valuation will be reduced from profits	2,20,000 x 10/110 = 20,000	5,00,000 x 5/100 = 25,000

2. Computation of Shares to be issued as purchase consideration

	White Ltd. ₹	*Black Ltd.* ₹
Profit before interest & tax	6,00,000	4,40,000
Less: Reduction in profit due to incorrect inventory valuation	(20,000)	(25,000)
Less: Debenture interest	______	(40,000)
Profit before tax	5,80,000	3,75,000
Less: Tax @ 40%	(2,32,000)	(1,50,000)
Profit after tax (PAT)	3,48,000	2,25,000
Less: Preference dividend	-	(80,000)
Profit available to equity shareholders [A]	3,48,000	1,45,000
Price Earnings Multiple [B]	15	10
Total Purchase Consideration to be given (A x B)	52,20,000	14,50,000
Equity Share Capital (Purchase Consideration x 100/125)	41,76,000	11,60,000
Securities Premium (25% of the above)	10,44,000	2,90,000

3. Bank Account

Date	Particulars		₹	Date	Particulars	₹
1.10.2016	To Share Application Money (20,00,000x₹ 14)		2,80,00,000	1.10.2016	By Futures Trading A/c	2,80,00,000
1.11. 2016	To 12.5% TOD		15,00,000	1.11.2016	By Preliminary Expenses	12,00,000
31.12.2016	To Future Trading A/c [(2,80,00,000 x (18/100) x (100/60) + 2,80,00,000}		3,64,00,000	31.12.2016	By Working Capital expenses	2,00,000
31.12.2016	To Dividend received			31.12.2016	By Dividends Paid [(41,76,000	1,86,760

					+ 11,60,000) x 3.5/100]	
	White Ltd (3,00,000 x 10 x 5%)	1,50,000		31.12.2016	By TOD Interest (15,00,000 x 12.5/100 x 2/12)	31,250
	Black Ltd. (1,20,000 x 10 x 2 %)	24,000	1,74,000	31.12.2016	By Debenture Interest (80,000 x ₹ 10 x 5/100 x 3/12)	10,000
				31.12.2016	By Preference Dividend (1,00,000 x ₹ 10 x 8/100 x 3/12)	20,000
				31.12.2016	By 12.5% TOD	15,00,000
				31.12.2016	By Balance c/d	3,49,25,990
			6,60,74,000			6,60,74,000

Amalgamation-Cross Holdings

Question 25

The following are the Balance Sheets of A Ltd. & B Ltd. as on 31st March, 2017:

Liabilities	*A Ltd.*	*B Ltd.*
Share Capital:		
Equity Shares of ₹ 10 each fully paid	45,00,000	10,00,000
8% Preference Shares of ₹ 10 each fully paid	-	5,00,000
General Reserve	3,50,000	3,10,000
Profit and Loss Account	6,34,000	60,000
10% Debentures	-	8,00,000
Current Liabilities	6,00,000	3,80,000
Total	60,84,000	30,50,000
Assets:		
Fixed Assets	30,50,000	7,30,000
30,000 Equity Shares in B Ltd.	3,00,000	-
90,000 Equity Shares in A Ltd.	-	10,00,000

Debtors	12,70,000	4,50,000
Stock	8,40,000	5,50,000
Bank Balance	6,24,000	3,20,000
Total	60,84,000	30,50,000

A Ltd. absorbs B Ltd. on the basis of intrinsic value of both the companies as on 31st March, 2017. It is informed that the Preference Shares of B Ltd. do not have priority over payment of capital and dividend. Before absorption, A Ltd. declared dividend of 8.8%.

Prepare Balance sheet of A Ltd., after the absorption of B Ltd. with necessary Notes to accounts.

Answer

Balance Sheet of A Ltd. (after absorption of B Ltd.) as on 31st March, 2017

		Particulars	Note No.	(₹)
I.	**Equity and Liabilities**			
	1.	Shareholders fund		
		a) Share capital	1	49,73,950
		b) Reserves and Surplus	2	7,56,040
	2.	Non-current liabilities		
		Long term borrowings		8,00,000
	3.	Current liabilities		9,80,000
		Total		75,09,990
II.	**Assets**			
	1.	Non-current Assets		
		Fixed Assets		
		Tangible Assets (₹ 30,50,000 + ₹ 7,30,000)		37,80,000
	2.	Current Assets		
		a) Inventories		13,90,000
		b) Trade receivables		17,20,000
		c) Cash and Cash equivalents		6,19,990
				75,09,990

Notes to Accounts:

		₹	₹
1.	**Share Capital**		
	4,97,395 Equity Shares of ₹ 10 each fully paid (out of which, 47,395 shares were allotted to vendors for consideration other than cash)		49,73,950

2.	**Reserves and surplus**		
	General Reserve	4,46,000	
	Profit and loss account (₹ 6,34,000 – ₹ 3,96,000)	2,38,000	
	Securities premium reserve (47,395 shares x ₹ 1.52)	72,040	7,56,040

Workings Notes:

(1) Computation of Net Assets (excluding inter-company investments)

	A Ltd.	*B Ltd.*
	₹	₹
Total Assets		
Assets Excluding invest	57,84,000	20,50,000
Dividend receivable	-	72,000
(A)	57,84,000	21,22,000
External Liabilities		
Current Liabilities	6,00,000	3,80,000
Dividend	3,96,000	-
10% Debentures	-	8,00,000
(B)	9,96,000	11,80,000
Net Assets (A)-(B)	47,88,000	9,42,000

Note: Since the Preference Shares of B Ltd. do not have priority over the payment of capital and dividend, they have to be treated at par with the equity shares. Both types of shares have the same paid up value.

(2) In view of the above, the proportion of shareholding in B Ltd. is worked out, as follows:

(a) **A Ltd. in B. Ltd.**

$$\frac{\text{Number of shares held by B Ltd.}}{\text{Total number of Equity and Preference Shares of B Ltd.}} = \frac{30{,}000}{1{,}00{,}000 + 50{,}000} = \frac{1}{5}$$

(b) **B Ltd. in A Ltd.**

$$\frac{\text{Number of shares held by B Ltd.}}{\text{Total number of Equity and A Ltd.}} = \frac{90{,}000}{4{,}50{,}000} = \frac{1}{5}$$

(3) Calculation of intrinsic value of shares:

Let 'a' be the intrinsic value of shares of A Ltd. and 'b' be the intrinsic value of shares of B Ltd.

Now, a = ₹ 47,88,000 + 1/5 x b

b = ₹ 9,42,000 + 1/5 x a

By substituting the value of a in b, we get

b = ₹ 9,42,000 + 1/5 (₹ 47,88,000 + 1/5 x b)

b = ₹ 9,42,000 + 9,57,600 + b/25

$$\frac{24\,b}{25} = ₹\ 18{,}99{,}600$$

$$b = \frac{₹\,18{,}99{,}600 \times 25}{24}$$

b = ₹ 19,78,750

$$a = ₹\ 47{,}88{,}000 + \frac{19{,}78{,}750}{5} = ₹\,51{,}83{,}750$$

$$\text{Intrinsic value of shares of A. Ltd.} = \frac{₹\,51{,}83{,}750}{4{,}50{,}000} = 11.52$$

$$\text{Intrinsic value of shares of B. Ltd.} = \frac{₹\ 19{,}78{,}750}{1{,}00{,}000 + 50{,}000} = ₹\ 13.19$$

(4) **Calculation of Purchase Consideration:**

No. of shares held by outside shareholders of B Ltd.

=1,00,000 – 30,000 + 50,000 = 1,20,000

Intrinsic value of shares = 1,20,000 x ₹ 13.19 per share

= 15,82,800

Shares to be issued on the basis of intrinsic value of shares

$$= \frac{₹\,15{,}82{,}800}{₹\,11.52} \qquad = 1{,}37{,}395.83 \text{ shares}$$

Less: Shares already held by A Ltd. = 90,000.00 Shares

Number of shares to be issued = 47,395.83 shares

(5) Total Purchase price

	₹
Additional shares in A. Ltd. (47,395 shares of ₹ 11.52)	5,45,990
Cash for fractional shares (0.83 x ₹ 11.52)	10
	5,46,000

Value of 30,000 shares already held by A Ltd. (30,000 shares x ₹ 13.19)	3,96,000*
Total	9,42,000

* Approximate figure has been considered.

(6) General Reserve

	₹
As per balance sheet	3,50,000
Add: Appreciation in the value of shares held B. Ltd. (₹ 3,96,000 – ₹ 3,00,000)	96,000
Closing balance	4,46,000

(7) Bank Balance

		A Ltd. ₹	B Ltd. ₹
As per balance sheet		6,24,000	3,20,000
Dividend received		-	72,000
		6,24,000	3,92,000
Less: Dividend payment	3,60,000		
Dividend tax @ 10%	36,000		
Cash for fraction shares	10	(3,96,010)	-
		2,27,990	3,92,000
Total bank balance			6,19,990

Question 26

The following are the Balance Sheets of Big Ltd. and Small Ltd. as at 31.3.15:

(₹ in lakhs)

	Big Ltd.	*Small Ltd.*		*Big Ltd.*	*Small Ltd.*
	₹	₹		₹	₹
Share Capital	*40*	*15*	*Sundry Assets (including cost of shares)*	*56*	*20*
Profit & Loss A/c	*7.5*	*--*	*Goodwill*	*4*	*5*
Sundry Creditors	*12.5*	*12.5*	*Profit and Loss A/c*	*--*	*2.5*
	60.0	*27.5*		*60.0*	*27.5*

Additional Information:

(i) The two companies agree to amalgamate and form a new company, Medium Ltd.

(ii) Big Ltd. holds 10,000 shares in Small Ltd. acquired at a cost of ₹ 2,50,000 and Small Ltd. holds 5,000 shares in Big Ltd. acquired at a cost of ₹ 7,00,000.

(iii) The shares of Big Ltd. are of ₹ 100 and are fully paid and the shares of Small Ltd. are of ₹ 50 each on which ₹ 30 has been paid-up.

(iv) It is agreed that the goodwill of Big Ltd. would be valued at ₹ 1,50,000 and that of Small Ltd. at ₹ 2,50,000.

(v) The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuation decided as given in (iv).

(vi) The new shares are to be of a nominal value of ₹ 50 each credited as ₹ 25 paid.

You are required to:

(i) Prepare the Balance Sheet of Medium Ltd., as at 31st March, 2017 after giving effect to the above transactions; and

(ii) Prepare a statement showing the shareholdings in the new company attributable to the shareholders of the merged companies.

Answer

(i) Balance Sheet of Medium Ltd. as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
Share Capital	1	45,50,000
(2) **Current Liabilities**		
Trade Payables		25,00,000
Total		70,50,000
II. Assets		
(1) **Non-current assets**		
Fixed assets		
Intangible assets	2	4,00,000
(2) **Current assets** (₹ 53,50,000+ ₹ 13,00,000)		66,50,000*
Total		70,50,000

* Sundry assets are assumed to be current assets.

Notes to Accounts:

		(₹ in crores)
1.	**Share Capital**	
	1,82,000 shares of ₹ 50 each, ₹ 25 paid up	45,50,000
	[Issued for consideration other than cash]	
2.	**Intangible Assets**	
	Goodwill (₹ 1,50,000 + ₹ 2,50,000)	4,00,000

(ii) Statement of Shareholding in Medium Ltd.

	Big Ltd. ₹	*Small Ltd.* ₹
Total value of Assets	44,20,513	8,52,564
Less: Pertaining to shares held by the other company	5,52,564	1,70,513
	38,67,949	6,82,051
Rounded off	38,67,950	6,82,050
Shares of new company (at ₹ 25 per share)	1,54,718	27,282
Total purchase consideration to be paid to Big Ltd and Small Ltd. (₹ 38,67,950 +₹ 6,82,050)		₹ 45,50,000
Number of shares in Big Ltd. (40,00,000/100)		40,000 shares
Number of shares in Small Ltd. (15,00,000/30)		50,000 shares
Holding of Small Ltd. in Big Ltd. (5,000/40,000)		1/8
Holding of Big Ltd. in Small Ltd. (10,000/50,000)		1/5
Number of shares held by outsiders in Big Ltd. (40,000 – 5,000) =		35,000
Number of shares held by outsiders in Small Ltd. (50,000 – 10,000)		40,000

Working Note:

Calculation of Book Value of Shares

	Big Ltd	*Small Ltd.*
	₹	₹
Goodwill	1,50,000	2,50,000
Sundry Assets other than shares in other company		
(56,00,000 – 2,50,000)	53,50,000	
(20,00,000 – 7,00,000)		13,00,000
	55,00,000	15,50,000
Less: Sundry Creditors	12,50,000	12,50,000
	42,50,000	3,00,000

If "x" is the Book Value of Assets of Big Ltd and "y" of Small Ltd.

$$x = 42,50,000 + \frac{1}{5}y$$

$$y = 3,00,000 + \frac{1}{8}x$$

$$x = 42,50,000 + \frac{1}{5}(3,00,000 + \frac{1}{8}x)$$

$$= 42,50,000 + 60,000 + \frac{1}{40}x$$

$$\frac{39}{40}x = 43,10,000$$

$$x = 43,10,000 \times \frac{40}{39}$$

$$x = 44,20,513 \text{ (approx.)}$$

$$y = 3,00,000 + \frac{1}{8}(44,20,513)$$

$$= 3,00,000 + 5,52,564 = ₹\ 8,52,564 \text{ (approx.)}$$

Book Value of one share of Big Ltd. = $\frac{44,20,513}{40,000}$ = ₹ 110.513 (approx.)

Book Value of one share of Small Ltd. = $\frac{8,52,564}{50,000}$ = ₹ 17.05 (approx.)

Question 27

AB Ltd. and MB Ltd. decide to amalgamate and to form a new company AM Ltd. The following are their summarised balance sheets as at 31.3.2017: (₹)

Liabilities	*AB Ltd.*	*MB Ltd.*	*Assets*	*AB Ltd.*	*MB Ltd.*
Share Capital			*Fixed Assets*	*7,50,000*	*2,00,000*
(₹ 100) each	*10,00,000*	*6,00,000*	*Investments:*		
General Reserve	*1,00,000*	*50,000*	*1,500 Shares in MB*	*3,50,000*	–
Investment Allowance			*4,000 Shares in AB*	–	*5,00,000*
Reserve	*40,000*	*30,000*			
12% Debentures			*Current Assets*	*4,00,000*	*1,00,000*

(₹ 100 each)	*3,00,000*	*1,00,000*			
Trade payables	*60,000*	*20,000*			
	15,00,000	*8,00,000*		*15,00,000*	*8,00,000*

Calculate the amount of purchase consideration for AB Ltd. and MB Ltd. and draw up the balance sheet of AM Ltd. after considering the following:

(a) Assume amalgamation is in the nature of purchase.

(b) Fixed assets of AB Ltd. are to be reduced by ₹ 50,000 and that of MB Ltd. are to be taken at ₹ 3,00,000.

(c) 12% debenture holders of AB Ltd. and MB Ltd. are discharged by AM Ltd. by issuing such number of its 15% debentures of ₹ 100 each so as to maintain the same amount of interest.

(d) Shares of AM Ltd. are of ₹ 100 each.

Also show, how the investment allowance reserve will be treated in the Financial Statement assuming the Reserve will be maintained for 3 years.

Answer

Calculation of Purchase consideration

(i) Value of Net Assets of AB Ltd. and MB Ltd. as on 31st March, 2017

		AB Ltd. (₹)		*MB Ltd.* (₹)
Assets taken over:				
Fixed Assets	7,00,000		3,00,000	
Current Assets	4,00,000	11,00,000	1,00,000	4,00,000
Less: Liabilities taken over:				
Debentures (WN)	2,40,000		80,000	
Trade payables	60,000	(3,00,000)	20,000	(1,00,000)
		8,00,000		3,00,000

(ii) Value of Shares of AB Ltd. and MB Ltd.

AB Ltd. holds 1,500 shares in MB Ltd. i.e. 1/4th of the shares of MB Ltd.

The value of shares of AB Ltd. is ₹ 8,00,000 plus 1/4 of the value of the shares of MB Ltd.

MB Ltd. holds 4,000 shares in AB Ltd. i.e. 2/5th of the shares of AB Ltd.

Similarly, the value of shares of MB Ltd. is ₹ 3,00,000 plus 2/5 of the value of shares of AB Ltd.

Let 'a' denote the value of shares of AB Ltd. and 'm' denote the value of shares of MB Ltd. then

$$a = 8,00,000 + 1/4\ m; \text{ and}$$
$$m = 3,00,000 + 2/5\ a.$$

Substituting the value of m,

$$a = 8,00,000 + 1/4\ (3,00,000 + 2/5\ a)$$
$$a = 8,00,000 + 75,000 + 1/10\ a$$
$$9/10\ a = 8,75,000$$
$$a = 9,72,222$$
$$m = 3,00,000 + 2/5\ (9,72,222)$$
$$m = 6,88,889$$

(iii) Amount of Purchase Consideration

	AB Ltd. ₹	*MB Ltd.* ₹
Total value of shares (as determined above)	9,72,222	6,88,889
Less: Internal investments:		
2/5 for shares held by MB Ltd.	(3,88,889)	
1/4 for shares held by AB Ltd.		(1,72,222)
Amount due to outsiders	5,83,333	5,16,667

Purchase Consideration will be satisfied by AM Ltd. as follows:

	AB Ltd. ₹	*MB Ltd.* ₹
In shares (of ₹ 100 each)	5,83,300	5,16,600
In cash	33	67

(iv) Net Amount of Goodwill/Capital Reserve

	₹	₹
Total Purchase Consideration		
AB Ltd.	5,83,333	
MB Ltd.	5,16,667	11,00,000
Less: Net Assets taken over		
AB Ltd.	8,00,000	
MB Ltd.	3,00,000	(11,00,000)
		Nil

(Alternatively, the calculations may be made separately for both the companies)

Balance Sheet of AM Ltd.
as at 31st March, 2017

Particulars	*Note No.*	*Amount (₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	10,99,900
(b) Reserves and Surplus	2	70,000
(2) **Non-Current Liabilities**		
Long-term borrowings	3	3,20,000
(3) **Current Liabilities**		
Trade payables		80,000
Total		15,69,900
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		10,00,000
(b) Other non-current assets	4	70,000
(2) **Current assets**	5	4,99,900
Total		15,69,900

Notes to Accounts

		(₹)	*(₹)*
1.	Share Capital		
	10,999 shares of ₹ 100 each		10,99,900
	(All the above shares are allotted as fully paid-up for consideration other than cash)		
2.	Reserves and surplus		
	Investment Allowance Reserve		70,000
3.	Long Term Borrowings		
	15% Debentures (W.N.)		3,20,000
4.	Other non-current assets		
	Amalgamation Adjustment Account		70,000
5.	Current assets [4,00,000 + 1,00,000]	5,00,000	
	Less: Purchase consideration paid in cash ₹ (33+67)	(100)	4,99,900

Working Note:

Calculation of Debentures to be issued

	AB Ltd.	*MB Ltd.*
12% Debentures	3,00,000	1,00,000
Interest on Debentures @ 12 % (a)	36,000	12,000
AM Ltd. Debentures rate of interest (b)	15 %	15 %
Debenture Value to earn above calculated interest (a/b)	2,40,000	80,000

Question 28

The summarized Balance Sheets of O Ltd. and P Ltd. as on 31st March, 2017 are as under:

(₹ in lakhs)

Liabilities	*O*	*P*	*Assets*	*O*	*P*
Equity Shares of ₹ 10 each	*25.00*	*50.00*	*Fixed Assets*	*110.00*	*50.00*
Reserves	*122.5*	*20*	*Investments*	*16.25*	*25.00*
12% Debentures	*11.00*	*5.50*	*Current Assets*	*40.25*	*3.25*
Trade payables	*8.00*	*2.75*			
	166.5	*78.25*		*166.5*	*78.25*

Investments of O Ltd. represent 1,25,000 shares of P Ltd. Investments of P Ltd. are considered worth ₹ 30 lakhs.

P Ltd. is taken over by O Ltd. on the basis of the intrinsic value of shares in their respective books of account.

Prepare a statement showing the number of shares to be allotted by O Ltd. to P Ltd. and the Balance Sheet of O Ltd. after absorption of P Ltd.

Answer

Balance Sheet of O Ltd.
(after absorption)

Particulars	*Note No.*	*(₹ in lakhs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	34.375
(b) Reserves and Surplus	2	171.875
(2) **Non-Current Liabilities**		
Long-term borrowings	3	16.500

(3) **Current Liabilities**		
Trade payables	4	10.750
Total		233.50
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
Tangible assets	5	160.00
(b) Non-current Investments		30.00
(2) **Current assets**	6	43.50
Total		233.50

Notes to Accounts

		(₹ in lakhs)	*(₹ in lakhs)*
1.	Share Capital		
	3,43,750 Equity Shares of ₹ 10 each		34.375
	(Of the above shares, 93,750 equity shares are allotted as fully paid-up for consideration other than cash)		
2.	Reserves and surplus		
	As per last Balance Sheet	122.5	
	Capital Reserve (W.N.3)	2.500	
	Securities Premium (W.N.2)	46.875	171.875
3.	Long Term Borrowings		
	12% Debentures	11.000	
	Add: Taken over	5.500	16.500
4.	Trade payables	8.000	
	Add: Taken over	2.750	10.750
5.	Tangible assets		
	Fixed Assets	110.000	
	Add: Taken over	50.000	160.000
6.	Current assets		
	Current Assets	40.250	
	Add: Taken over	3.250	43.500

Working Notes:

1.

(i)	*Calculation of Net Assets*		*(₹ in lakhs)*
		O Ltd.	*P Ltd.*
	Fixed Assets	110.00	50.00
	Investments [1.25 lakh shares X ₹ 15*]	18.75	30.00
	Current Assets	40.25	3.25
	Total (A)	169.00	83.25
	12% Debentures	11.00	5.50
	Trade payables	8.00	2.75
	Total (B)	19.00	8.25
	Net Assets (A – B)	150.00	75.00
(ii)	Number of equity shares	2.50 lakhs	5.00 lakhs
	Intrinsic Value	₹ 60.00	₹ 15.00*

2. Calculation of Shares Allotted

	(₹ in lakhs)
Net assets taken over	75.00
Less: Belonging to O Ltd. $\left(\frac{1,25,000}{5,00,000} \times 75 \text{ lakhs}\right)$	(18.75)
Payable to other equity shareholders	56.25
Number of equity shares of ₹ 10 each to be issued = $\frac{56,25,000}{60}$	
= 93,750 shares (valued at ₹ 60 each)	
Credit to share capital	₹ 9,37,500
Credit to securities premium	₹ 46,87,500

3. Calculation of Capital Reserve / Goodwill

Fixed Assets	50.00
Investments	30.00
Current Assets	3.25
Total of Assets	83.25

12% Debentures	(5.50)
Trade payables	(2.75)
Net Assets taken over	75.00
Less: Investments of O Ltd. in P Ltd.	(16.25)
	58.75
Purchase Consideration	56.25
Capital Reserve	2.5

Question 29

The following are the summarized Balance Sheets of X Ltd. and Y Ltd. as on 31st March, 2017:

		Amount in ₹
	X Ltd.	*Y Ltd.*
Assets		
Fixed Assets	*7,00,000*	*2,50,000*
Inventory	*2,40,000*	*3,20,000*
Trade receivables	*4,20,000*	*2,10,000*
Cash at Bank	*1,10,000*	*40,000*
Investments in:		
6,000 shares of Y Ltd.	*80,000*	
5,000 shares of X Ltd.		*80,000*
	15,50,000	*9,00,000*
Liabilities		
Share Capital:		
Equity shares of ₹ 10 each	*6,00,000*	*3,00,000*
10% preference shares of ₹ 10 each	*2,00,000*	*1,00,000*
Reserve and Surplus	*3,00,000*	*2,00,000*
12% Debentures	*2,00,000*	*1,50,000*
Trade payables	*2,50,000*	*1,50,000*
	15,50,000	*9,00,000*

Details of Trade payables and Trade receivables:

	X Ltd.	*Y Ltd.*
Trade payables		
Bills Payable	*30,000*	*25,000*

Sundry creditors	*2,20,000*	*1,25,000*
	2,50,000	*1,50,000*
Trade receivables		
Debtors	*3,60,000*	*1,90,000*
Bills Receivables	*60,000*	*20,000*
	4,20,000	*2,10,000*

Fixed assets of both the companies are to be revalued at 15% above book values and inventory and debtors are to be taken over at 5% less than their book values. Both the companies are to pay 10% equity dividends, preference dividends having been paid already.

After the above transactions are given effect to, X Ltd. will absorb Y Ltd. on the following terms:

(i) 8 equity shares of ₹ 10 each will be issued by X Ltd. at par against 6 shares of Y Ltd.

(ii) 10% preference shares of Y Ltd. will be paid off at 10% discount by issue of 10% preference shares of ₹ 100 each of X Ltd. at par.

(iii) 12% Debenture holders of Y Ltd. are to be paid off at a 8% premium by 12% debentures in X Ltd. issued at a discount of 10%.

(iv) ₹ 30,000 to be paid by X Ltd. to Y Ltd. for liquidation expenses.

(v) Creditors of Y Ltd. include ₹ 10,000 due to X Ltd.

Prepare: (a) A statement of purchase consideration payable by X Ltd.

(b) A Balance Sheet of X Ltd. after its absorption of Y Ltd.

Answer

Total No. of shares of X Ltd. = 6,00,000/10 = 60,000 shares

X Ltd's shares held by Y Ltd. = 5,000 shares

Total No. of shares of Y Ltd. = 3,00,000/10 = 30,000 shares

Y Ltd's shares held by X Ltd. = 6,000 shares

Hence, X Ltd. hold's 1/5th (6,000/30,000) of Y Ltd.'s total shares

(a) Statement of Purchase Consideration payable by X Ltd.

(i) **For Equity Shareholders**

8 Equity Shares of X Ltd. for every 6 Equity Shares of Y Ltd.

	30,000 shares x $\frac{8}{6}$ =	40,000 shares
Less:1/5th Share of X Ltd.		(8,000) shares
	Balance for outsiders	32,000 shares

Less: 5,000 Shares of X Ltd. already with Y Ltd.	(5,000) shares
Shares to be issued	27,000 shares
Value of 27,000 equity shares at ₹ 10	₹ 2,70,000

(ii) **For Preference Shareholders**

Preference Share Capital of Y Ltd.	₹ 1,00,000
Less: 10% Discount	₹ 10,000
X Ltd.'s Preference shares to be issued	₹ 90,000

Total Purchase Consideration

Particulars	*Numbers*	*Amount*
Equity Shares @ ₹ 10 each	27,000	₹ 2,70,000
Preference Shares @ ₹ 100 each	900	₹ 90,000
Total Purchase Consideration		₹ 3,60,000

(b) Balance Sheet of X Ltd. after its absorption of Y Ltd.

Particulars	*Note No.*	*₹*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	11,60,000
(b) Reserves and Surplus	2	3,76,000
(2) **Non-Current Liabilities**		
Long-term borrowings	3	3,80,000
(3) **Current Liabilities**		
Trade payables	4	3,90,000
Total		23,06,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets [7,00,000 X 115 % + 2,87,500]		10,92,500
(b) Other non-current assets	5	18,000
(2) **Current assets**		
(a) Inventories (2,40,000 + 3,04,000)		5,44,000
(b) Trade receivables	6	6,10,500
(c) Cash and cash equivalents	7	41,000
Total		23,06,000

Notes to Accounts

		₹	₹
1.	Share Capital		
	Equity share capital		
	87,000 (60,000 + 27,000) Equity shares of ₹ 10 each, fully paid up	8,70,000	
	(Out of the above, 27,000 equity shares have been issued for consideration other than cash)		
	20,000 10% Preference shares of ₹ 10 each	2,00,000	
	900 10% Preference shares of ₹ 100 each	90,000	11,60,000
2.	Reserves and Surplus		
	Revaluation Reserve [15 % of ₹ 7,00,000]	1,05,000	
	Capital Reserve (W. N.1)	25,000	
	Other Reserves (W.N.4)	2,46,000	3,76,000
3.	Long Term Borrowings		
	Secured (assumed)		
	12% Debentures Existing	2,00,000	
	Add: Issued to Y Ltd. [W.N. 5, Calculation (B)]	1,80,000	3,80,000
4.	Trade payables		
	Creditors (2,20,000 + 1,25,000 – 10,000)	3,35,000	
	Bills Payable (30,000 + 25,000)	55,000	3,90,000
5.	Other non-current assets		
	Discount on issue of Debentures [W.N. 5, Calculation (C)]		18,000
6.	Trade receivables		
	Debtors (3,60,000 + 1,80,500 – 10,000)	5,30,500	
	Bills Receivable (60,000 + 20,000)	80,000	6,10,500
7.	Cash & cash equivalents		
	Cash at Bank (W.N. 3)		41,000

Working Notes:

1. Calculation of Capital Reserve

Net Assets taken over from Y Ltd.	₹
Fixed Assets (₹ 2,50,000 × 115%)	2,87,500

Inventory (₹ 3,20,000 x 95%)	3,04,000
Debtors (₹ 1,90,000 x 95%)	1,80,500
Bills Receivable	20,000
Cash at Bank (W.N. 2)	15,000
Total Assets (A)	8,07,000
Liabilities taken over:	
Debentures [W.N. 5, Calculation (A)]	1,62,000
Creditors	1,25,000
Bills Payable	25,000
Total Liabilities (B)	3,12,000
Net Asset taken over (A – B)	4,95,000
Less: Investment cancelled (i.e. 5,000 shares held in × Ltd.)	(80,000)
	4,15,000
Purchase Consideration	(3,60,000)
Capital Reserve	55,000
Less: Liquidation expenses reimbursed to Y Ltd.	(30,000)
Capital Reserve	25,000

2. Cash taken over from Y Ltd.

	₹
Cash balance given in Balance Sheet of Y Ltd.	40,000
Add: Dividend received from X Ltd. (5,000 shares ×₹ 1)	5,000
	45,000
Less: Dividend paid (30,000 shares ×₹ 1)	(30,000)
	15,000

3. Cash balance in Balance Sheet (after absorption)

			₹
Cash balance given in Balance Sheet of X Ltd.			1,10,000
Add: Cash taken over from Y Ltd. (W.N. 2)			15,000
			1,25,000
Less:	Dividend paid	₹60,000	
	Expenses on liquidation	₹30,000	(90,000)
			35,000
Add: Dividend from Y Ltd.			6,000
			41,000

4. Other Reserves in the Balance Sheet (after absorption)

	₹
Reserves given in the Balance Sheet of X Ltd.	3,00,000
Add: Dividend from Y Ltd. [6,000 shares X ₹ 1)	6,000
	3,06,000
Less: Dividend declared [60,000 shares X ₹ 1)	(60,000)
	2,46,000

5. Debenture Holders Payment

Debenture Holders of Y Ltd.		₹ 1,50,000
Add: Premium @ 8 %		₹ 12,000
Value of Debenture Holder Liability taken over by X Ltd.	(A)	₹ 1,62,000
Issue Price of X Ltd. Debentures @ 10 % discount [(A) / 90 %]	(B)	₹ 1,80,000
Discount on Issue of Debentures	(C)	₹ 18,000

6 Inter-company transactions

Creditors of Y Ltd. include ₹ 10,000 due to X Ltd.

Therefore, journal entry in the books of X Ltd. will be

Creditors A/c	Dr.	10,000	
To Debtors A/c			10,000

Internal Reconstruction

Question 30

The shareholders of Sunrise Ltd. decided on a corporate restructuring exercise necessitated due to economic recession and a slump in business. From the audited statements as on 31-3-2017 and the information supplied, you are requested to prepare:

(i) Balance Sheet after the completion of the restructuring exercise,

(ii) The capital reduction account,

(iii) The cash account of the entity.

Balance Sheet of Sunrise Ltd. as on 31.3.2017

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	*4,00,000*	*Goodwill at cost*	*36,100*

shares ₹ 10 each			
Reserves and Surplus		*Freehold Land*	*1,20,000*
Securities Premium Account	*10,000*	*Freehold Premises*	*2,44,000*
Profit and Loss Account	*(1,38,400)*	*Plant and Equipment*	*3,20,000*
Secured Borrowings: *9% Debentures (₹ 100) 1,20,000*		*Investment (marked to Market)*	*64,000*
Accrued Interest 5,400	*1,25,400*	*Current Assets*	
Trade payables	*1,20,000*	*Inventories:*	
Deferred vat payable	*50,000*	*Raw materials and*	
Temporary bank overdraft	*2,23,100*	*packing materials 60,000*	
		Finished goods 16,000	*76,000*
		Trade receivable	*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 ₹ 3 lakhs and equity capital 7 lakhs both ₹ 10 shares 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) *The securities premium is to be fully utilized to meet the reconstruction programme.*

(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 on condition that claim will be immediately settled.*

(8) *The intangible assets were all to be written off along with ₹ 10,000 worth obsolete packing material and 10% of the receivables.*

(9) *Expenses for the scheme were ₹ 10,000.*

(10) *Remaining cash available as a result of the above transactions is to be utilized to pay off the bank overdraft to that extent.*

(11) The Equity shareholders agree that they will bring in cash to liquidate the balance outstanding on the overdraft account and also agree that sufficient funds will be bought in to bring up the net working capital, after completing the re-structuring exercise, to ₹ 2 lakhs. The equity shares will be issued at par for this purpose.

Answer

Balance Sheet of Sunrise Ltd. (and reduced) as on 31.3.2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	7,64,000
(2) **Non-Current Liabilities**		
Deferred vat payable		50,000
(3) **Current Liabilities**		
Trade payables		1,20,000
Total		9,34,000
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	2	5,64,000
(2) **Current assets**		
(a) Inventories	3	66,000
(b) Trade Receivables (1,20,000 – 12,000)		1,08,000
(c) Cash and cash equivalents		1,96,000
Total		9,34,000

Notes to Accounts

		`	`
1.	Share Capital		
	Authorised share capital:		
	70,000 Equity shares of ₹ 10 each	7,00,000	
	30,000 Preference shares of ₹ 10 each	3,00,000	
		10,00,000	

	Issued share capital:		
	56,400 Equity shares of ₹10 each (W.N.2)	5,64,000	
	(Out of the above 3,200 equity shares have been issued for consideration other than cash)		
	20,000 Preference shares of ₹10 each (W.N.2)	2,00,000	7,64,000
2.	Tangible Assets		
	Freehold premises	2,44,000	
	Plant & equipment	3,20,000	5,64,000
3.	Inventories:		
	Raw materials and packing materials (60,000 – 10,000)	50,000	
	Finished goods	16,000	66,000
4.	Trade receivables (1,20,000-12,000)		1,08,000

Capital Reduction Account

	Particulars	₹		*Particulars*	₹
To	Equity share capital	32,000	By	Preference share capital	2,00,000
To	Cash (contingent liability settled)	54,000	By	Equity share capital	90,000
To	Trademarks and Patents	1,10,000	By	Freehold land (2,10,000-1,20,000)	90,000
To	Goodwill	36,100	By	Cash (insurance claim)	12,500
To	Raw material and Packing materials	10,000			
To	Trade receivables	12,000			
To	Profit and loss account	1,38,400			
		3,92,500			3,92,500

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	Securities Premium – Expenses (See Note)	10,000
To	Capital reduction (insurance claim)	12,500	By	Temporary bank overdraft (64,000+84,600+12,500-54,000-10,000) 97,100	
To	Equity share capital	3,22,000			

		By	Temporary bank overdraft (2,23,100 – 97,100) 1,26,000	2,23,100
		By	Balance c/d (W.N.1)	1,96,000
	4,83,100			4,83,100

Working Notes:

1. Calculation of cash brought in by Equity shareholders:

		₹
Net working capital:		
Raw Materials & Packing materials		50,000
Finished goods		16,000
Trade Receivables		1,08,000
		1,74,000
Less: Trade payables	1,20,000	
Deferred VAT payable	50,000	(1,70,000)
		4,000
Add : Cash brought in to maintain net working capital of ₹ 2,00,000 (Bal.fig.)		1,96,000
Desired net working capital		2,00,000

2. Determination of number of shares issued

	Equity shares		*Preference shares*	
	₹	*No. of shares*	₹	*No. of shares*
Share capital as per balance sheet before reconstruction	3,00,000		4,00,000	
Less: Capital reduction	(90,000)		(2,00,000)	
Share capital of ₹ 7 each	2,10,000			
Share capital of ₹ 5 each			2,00,000	
Consolidated value per share	10	21,000	10	20,000
Add: Shares issued against arrears of preference dividend (₹ 4,00,000 x 8% x 4 years) /₹ 40		3,200		
Add: Shares issued to existing equity shareholders for bringing cash for payment of balance of bank overdraft (1,26,000/10)		12,600		
Add: Shares issued to existing equity shareholders for bringing cash for				

maintaining net working capital of ₹ 2,00,000 (1,96,000/10)		19,600		____
		56,400		20,000

Note: As per section 52 of the Companies Act, 2013, securities premium can be utilized only for limited purpose. Since, the question requires utilization of securities premium to meet the reconstruction programme, it is assumed that 'Expenses for the scheme ₹ 10,000' has been incurred on account of issue of shares to existing shareholders which is an eligible expense to be set off against securities premium amount.

Question 31

The summarised Balance Sheets of 'S' Limited and 'H' Limited as on 30th June 2016 were as follows: *₹ in crores*

	S Limited		***H Limited***	
Equity and Liabilities				
Equity share capital		*80*		*25*
Reserves and surplus		*400*		*75*
Non-current Liabilities				
10%, 25,00,000 Debentures of ₹ 100 each				*25*
Other non-current liabilities		*120*		
Current Liabilities		*356*		*200*
Total		*956*		*325*
Assets				
Fixed assets (At cost)	*200*		*75*	
Less: Depreciation	*(100)*	*100*	*(50)*	*25*
Investment in 'H' Limited				
2 Crores Equity shares of ₹ 10 each at cost	*32*			
10%, 25,00,000 Debentures of ₹ 100 each at cost	*24*	*56*		
Current Assets		*800*		*300*
Total		*956*		*325*

In a duly approved scheme of absorption, 'S' Limited took over the assets of 'H' Limited at an agreed value of ₹ 330 crores and the liabilities were taken over at book value. Other shareholders of 'H' Limited were allotted equity shares in 'S' Limited at a premium of ₹ 90 per share in satisfaction of their claim. 'S' Limited valued the fixed assets taken over at ₹ 40 crores and all other assets and liabilities were recorded at book value. The scheme of absorption was completed on 1st July 2016.

You are required to:

(a) Pass necessary Journal Entries in the books of 'S' Limited to record the transactions.

(b) *Prepare the Balance Sheet of 'S' Limited after absorption in the Schedule III format along with Notes to accounts.*

Answer

(a) Journal Entries in the books of 'S' Limited

			(₹ in crores)	
			Dr.	*Cr.*
1.	Business Purchase Account (W.N.1)	Dr.	105	
	To Liquidator of H Ltd.			105
	(Being business purchased from H Ltd.)			
2.	Fixed Assets Account	Dr.	40	
	Current Assets Account	Dr.	300	
	To 10% Debentures Account of H Ltd.			25
	To Current Liabilities Account			200
	To Business Purchase Account			105
	To Capital Reserve Account			10
	(Being incorporation of various assets and liabilities taken over from H Ltd. at agreed values)			
3.	10% Debentures of H Ltd. Account	Dr.	25	
	To Investment in 10% Debentures of H Ltd.			24
	To Capital Reserve Account			1
	(Being offsetting of 10% debentures held as liability as well as investment in debentures of H Ltd. and transferring the difference to capital reserve)			
4.	Liquidator of H Ltd. Account	Dr.	21	
	To Equity share capital Account			2.10
	To Securities Premium Account			18.90
	(Being discharge of purchase consideration to outside shareholders of H Ltd.)			
5.	Liquidator of H Ltd.		84	
	To Investment in Equity shares of H Ltd.			32
	To Capital Reserve Account			52
	(Being Investment in H Ltd. cancelled and the resultant profit transferred to capital reserve account)			

(b) **Balance Sheet of S Ltd. as at 1st July, 2016 (after absorption)**

Particulars	*Note No.*	*(₹ in crores)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	82.10
(b) Reserves and Surplus	2	481.90
(2) **Non-current Liabilities**		
Other non-current liabilities	3	120.00
(3) **Current Liabilities**	4	556.00
		1,240.00
II. Assets		
(1) Fixed assets	5	140.00
(2) Current assets	6	1,100.00
Total		1,240.00

Notes to Accounts

			(₹ in crores)
1.	**Share Capital**		
	8.21 crores equity shares of ₹ 10 each		82.10
	(Out of the above, 0.21 crores equity shares has been issued for consideration other than cash)		
2.	**Reserves and Surplus**		
	As already shown in the S Ltd.'s balance sheet	400.00	
	Capital Reserve (1+52+10)	63.00	
	Securities Premium	18.90	481.90
3.	**Other non-current liabilities**		
	S Limited		120
4.	**Current Liabilities**		
	S Limited	356	
	Add: Taken over from H Limited	200	556
5.	**Fixed assets**		
	S Limited	100	
	Add: Taken over from H Limited	40	140
6.	**Current assets**		
	S Limited	800	
	Add: Taken over from H Limited	300	1,100

Working Notes:

1. **Calculation of Purchase consideration to outside shareholders of H Ltd.**

		(₹ in crores)
Assets of H Ltd. taken over at agreed value		330
Less: Liabilities taken over at		
10% Debentures	25	
Current liabilities	200	(225)
Net assets of H Ltd./Purchase consideration		105
Less: Shares held by S Ltd. (80%)		(84)
Payable to outside shareholders @ ₹ (10 + 90)		21
Number of Equity Shares to be issued 21/100 = 21,00,000 lacs		
Nominal value of Equity shares of S Ltd. paid to outside shareholders (21/100 x 10)		2.10
Securities premium (21/100 x 90)		18.90

Question 32

XY Limited has been incorporated with an authorised capital of 70 lacs equity shares of ₹ 10 each and 4 lacs preference shares of ₹ 100 each.

The subscribers to the Memorandum of Association have subscribed and paid for 1 lac equity shares. The expenses for incorporation incurred amounted to ₹ 8.09 lacs.

XY Limited desires to amalgamate X Limited and Y Limited as at 31st March, 2017. Following information is available:

Balance Sheet as on 31st March, 2017

		(₹ in lacs)
	X Limited	***Y Limited***
Liabilities		
Equity Shares (FV ₹ 100)	*750*	*725*
10% Preference shares (FV ₹ 100)	*420*	*180*
Reserves and Surplus		
Revaluation Reserve	*125*	*75*
Capital reserve	*270*	*190*
Statutory Reserves	*60*	*40*
Profit and Loss Account	*35*	*12*
Loan funds		
Secured Loans		
12.5% Debentures (FV ₹ 100)	*50*	*28*

Unsecured Loans		*25*	*0*
Current Liabilities			
Trade Payables		*165*	*75*
	Total	***1,900***	***1,325***
Assets			
Fixed Assets			
Land and Building		*470*	*290*
Plant and Machinery		*310*	*210*
Investments		*75*	*50*
Current Assets			
Trade Receivables		*345*	*270*
Inventories		*345*	*254*
Cash and cash equivalents		*355*	*251*
	Total	***1,900***	***1,325***

Before amalgamation, X Ltd. and Y Ltd. will make the following adjustments in their balance sheets:

(i) Pay off the unsecured loans.

(ii) X Limited will revalue its Land and Building by enhancing the book value by 10% and Y Limited will revalue the Land and Building at ₹ 330 lacs.

(iii) Y Limited will revalue its Plant and Machinery at ₹ 220 lacs.

(iv) Investment will be disposed of X Limited sold its investments for ₹ 67 lacs and Y Limited disposed the same for ₹ 52 lacs.

(v) Debenture holders of X Limited and Y Limited will be discharged by XY Limited by issue of 15% debentures of ₹ 100 each for such an amount which will not put any additional burden of interest outgo on XY Limited than presently payable by X Limited and Y Limited.

(vi) Preference shareholders of X Limited and Y Limited will be issued 15% Preference Shares in XY Limited in the ratio 2: 3 i.e. 2 shares will be issued for every 3 shares held at a premium of ₹ 25.

(vii) Equity shares in XY Limited will be issued as under:

(a) Shareholders of X Limited in the ratio of 4:1 @ ₹ 35 per share; and

(b) Shareholders of Y Limited in the ratio of 3:1 @ ₹ 32 per share.

(viii) Statutory reserves having met its purpose will be merged with Capital Reserves.

Prepare the amalgamated Balance Sheet of XY Limited as on 31st March, 2017 as per Schedule III to the Companies Act, 2013 with Notes to Accounts.

Answer

Balance Sheet of XY Ltd.

As on 31st March, 2017

Particulars	*Note No.*	*(₹ in lacs)*
I. Equity and Liabilities		
(1) Shareholder's funds		
(a) Share capital	1	927.50
(b) Reserves and surplus	2	2060.41
(2) Non-current liabilities		
Long-term borrowings	3	65.00
(3) Current liabilities		
Trade payables	4	240.00
Total		3,292.91
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	5	1,377
(2) Current assets		
(a) Inventories	6	599
(b) Trade receivables	7	615
(c) Cash & cash equivalents	8	701.91
Total		3,292.91

Notes to Accounts

		(₹ in lacs)	*(₹ in lacs)*
1.	Share Capital		
	Authorised share capital		
	70 lacs Equity shares @ ₹ 10 each		700
	4 lacs 15% Preference shares @ ₹ 100 each		400
			1,100
	Issued share capital		
	52.75 lacs Equity shares of ₹ 10 each	527.50	
	4 lacs 15% Preference shares of 100 each	400.00	927.50
	(Out of the above, 51.75 lacs Equity shares and 4 lacs		

	Preference shares are issued for consideration other than cash)		
2.	Reserves and surplus		
	Capital Reserve (W.N.1)	740.00	
	Securities Premium Reserve (W.N.5)	1,328.50	
	Profit and Loss A/c (Incorporation expenses)	(8.09)	2,060.41
3.	Long term borrowings		
	15% Debentures of ₹ 100 each		
	X Ltd.	41.67	
	Y Ltd.	23.33	65.00
4.	Trade payables		
	X Ltd.	165.00	
	Y Ltd.	75.00	240.00
5.	Tangible assets		
	Land & building		
	X Ltd.	517.00	
	Y Ltd.	330.00	847.00
	Plant & machinery		
	X Ltd.	310.00	
	Y Ltd.	220.00	530.00
			1,377.00
6.	Inventories		
	X Ltd.	345.00	
	Y Ltd.	254.00	599.00
7.	Trade Receivables		
	X Ltd.	345.00	
	Y Ltd.	270.00	615.00
8.	Cash and Cash equivalents		
	X Ltd. (W.N.2)	397.00	
	Y Ltd. (W.N.2)	303.00	700.00
	XY Ltd.		
	Received from subscribers of shares	10.00	
	Less: Incorporation expenses paid	(8.09)	1.91
			701.91

Note: As per AS 26 preliminary expenses are charged to Profit and loss account in the year in which it is incurred. Accordingly, the treatment for incorporation expense has been done.

Working Notes:

1. Calculation of Capital Reserve on amalgamation

				(₹ in lacs)
		X Ltd.		*Y Ltd.*
Assets taken over:				
Land and Building	(470 x 110%)	517		330
Plant and Machinery		310		220
Inventories		345		254
Trade receivables		345		270
Cash and Bank (W.N.2)		397		303
		1,914		1,377
Less : Liabilities taken over:				
13% Debentures (W.N.3)	41.67		23.33	
Trade payables	165.00	(206.67)	75.00	(98.33)
Net Assets taken over		1707.33		1,278.67
Less: Purchase consideration (W.N.4)		(1,400)		(846)
Capital Reserve		307.33		432.67
Total capital reserve (307.33 + 432.67) = 740.00 lacs				

2. Calculation of Cash and Cash Equivalents

	X Ltd. *₹ in lacs*	*Y Ltd.* *₹ in lacs*
Balance as per the Balance Sheet	355.00	251.00
Less: Payment for unsecured loans	(25.00)	-
Add: Receipt from sale of investments	67.00	52.00
	397.00	303.00

3. Calculation of 15% Debentures issued by XY Ltd.

	X Ltd. *₹ in lacs*	*Y Ltd.* *₹ in lacs*
$50 \times \frac{12.5}{15}$	41.67	
$28 \times \frac{12.5}{15}$		23.33

4. Computation of Purchase consideration (On Payment Basis)

		(₹ in lacs)	
		X Ltd.	*Y Ltd.*
(1)	15% Preference Shares:		
	(4.20/3) x 2 = 2.80 lacs shares @ ₹ 125 each	350	
	(1.80/3) x 2 = 1.20 lacs shares @ ₹ 125 each		150
2.	Equity Shares:		
	(4 × 7,50,000) = 30,00,000 equity shares @ ₹ 35 each	1050	
	(3 × 7,25,000) = 21,75,000 equity shares @ ₹ 32 each		696
		1,400	846

5. Calculation of Securities Premium

	₹ in lacs
15% Preference Shares issued at premium of ₹ 25 each (4 lacs x ₹ 25 each)	100
Equity Shares issued to - X Ltd. (30 lacs x ₹ 25 each)	750
Y Ltd. (21.75 lacs x ₹ 22 each)	478.50
	1,328.50

Exercise

Question 1

The summarized Balance Sheets of A Ltd. and its subsidiary B Ltd. as on 31.3.2017 are as follows:

	A Ltd. ₹	*B Ltd.* ₹
Shares of ₹ 10 each	*1,00,00,000*	*20,00,000*
Reserves and Surplus	*1,40,00,000*	*60,00,000*
Secured Loans	*40,00,000*	*–*
Current Liabilities	*60,00,000*	*20,00,000*
	3,40,00,000	*1,00,00,000*
Fixed Assets	*1,20,00,000*	*35,00,000*
Investment in B Ltd.	*7,40,000*	*–*
Trade receivables	*70,00,000*	*10,00,000*
Inventories	*60,00,000*	*50,00,000*
Cash and Bank	*82,60,000*	*5,00,000*
	3,40,00,000	*1,00,00,000*

A Ltd. holds 76% of the paid up capital of B Ltd. The balance shares in B Ltd. are held by a Foreign Collaborating company. A memorandum of understanding has been entered into with the foreign company providing for the following:

(a) The shares held by the foreign company will be sold to A Ltd. The price per share will be calculated by capitalizing the yield at 16%. Yield, for this purpose, would mean 40% of the average of pre-tax profits for the last 3 years, which were ₹ 35 lakhs. ₹ 44 lakhs and ₹ 65 lakhs.

(b) The actual cost of shares to the foreign company was ₹ 2,40,000 only. The profit that would accrue to them would be taxable at an average rate of 30%. The tax payable be deducted from the proceeds and A Ltd. will pay it to the Government.

(c) Out of the net consideration, 50% would be remitted to the foreign company immediately and the balance will be an unsecured loan repayable after one year. It was also decided that A Ltd. would absorb B Ltd. simultaneously by writing down the Fixed Assets of B Ltd. by 5%. The Balance Sheet figures included a sum of ₹ 1,50,000 due by B Ltd. to A Ltd.

The entire arrangement was approved by all concerned for giving effect to on 1.4.2017.

You are required to show the Balance Sheet of A Ltd. as it would appear after the arrangement is put through on 1.4.2017.

[Answer: Total of the balance sheet of A Ltd. ₹ 410.99 Lakhs; Yield of B Ltd.:₹ 19.2 lakhs; Price per share of B Ltd. =₹ 60; Purchase consideration for 24% of share capital of B Ltd. = ₹ 28.80 lakhs; Capital Reserve to A Ltd. ₹ 42.05 lakhs; Cash and bank balance of A Ltd. after acquisition of shares ₹ 69.24 lakhs.

Discharge of Purchase Consideration:

(i) as Tax :₹ 7.92 lakhs

(ii) 50% of (28.80 – 7.92 i.e. ₹ 20.88 lakhs) = ₹ 10.44 lakhs (to be remitted immediately)

(iii) Balance 50% = ₹ 10.44 lakhs (to be retained as unsecured loan)]

Question 2

Travels & Tours Ltd. has two divisions – 'Inland' and 'International'. The Balance Sheet as at 31st December, 2016 was as under:

	Inland (₹ crores)	International (₹ crores)	Total (₹ crores)
Fixed Assets:			
Cost	600	600	1,200
Depreciation	500	200	700
W.D.V. (written down value) (A)	100	400	500
Net Current Assets:			
Current assets	400	300	700

Less: Current liabilities	200	200	400
(B)	200	100	300
Total (A + B)	300	500	800
Financed by:			
Loan funds:			
(Secured by a charge on fixed assets)	–	100	100
Own Funds:			
Equity capital (fully paid up ₹ 10 shares)			50
Reserves and surplus			650
	?	?	700
Total	300	500	800

It is decided to form a new company 'IT Ltd.' for international tourism to take over the assets and liabilities of international division.

Accordingly 'IT Ltd.' was formed to takeover at Balance Sheet figures the assets and liabilities of international division. 'IT Ltd.' is to allot 5 crores equity shares of ₹ 10 each in the company to the members of 'Travels & Tours Ltd.' in full settlement of the consideration. The members of 'Travels & Tours Ltd.' are therefore to become members of 'IT Ltd.' as well without having to make any further investment.

(a) You are asked to pass journal entries in relation to the above in the books of 'Travels & Tours Ltd.' and also in 'IT Ltd.'. Also show the Balance Sheets of both the companies as on 1st January, 2017 showing corresponding figures, before the reconstruction also.

(b) The directors of both the companies ask you to find out the net asset value of equity shares pre and post-demerger.

(c) Comment on the impact of demerger on "shareholders wealth".

[Answer: Loss on reconstruction ₹ 400 crores, Total of the balance sheet of Travels & Tours Ltd. before and after reconstruction would be ₹ 800 crores and ₹ 300 crores respectively.

Net Asset Value of an equity share	**Pre-Demerger**	**Post-Demerger**
Travels & Tours Ltd.	**= ₹ 140**	**= ₹ 60]**

Question 3

System Ltd. and HRD Ltd. decided to amalgamate as on 01.04.2017. Their Balance Sheets as on 31.03.2017 were as follows: (₹ in '000)

Particulars	System Ltd.	HRD Ltd.
Source of Funds :		
Equity share capital (₹ 10 each)	150	140
9% preference share Capital (₹ 100 each)	30	20

Investment allowance Reserve	*5*	*2*
Profit and Loss Account	*10*	*6*
10 % Debentures	*50*	*30*
Trade payables	*25*	*15*
Tax provision	*7*	*4*
Equity Dividend Proposed	*30*	*28*
Total	*307*	*245*
Application of Funds :		
Building	*60*	*50*
Plant and Machinery	*80*	*70*
Investments	*40*	*25*
Trade receivables	*45*	*35*
Inventory	*36*	*40*
Cash and Bank	*40*	*25*
Preliminary Expenses	*6*	—
Total	*307*	*245*

From the following information, you are to prepare the draft Balance Sheet as on 01.04.2017 of a new company, Intranet Ltd., which was formed to take over the business of both the companies and took over all the assets and liabilities:

(i) *50% Debenture are to be converted into Equity Shares of the New Company.*

(ii) *Out of the investments, 20% are non-trade investments.*

(iii) *Fixed Assets of Systems Ltd. were valued at 10% above cost and that of HRD Ltd. at 5% above cost.*

(iv) *10% of trade receivables were doubtful for both the companies. Inventories to be carried at cost.*

(v) *Preference shareholders were discharged by issuing equal number of 9% preference shares at par.*

(vi) *Equity shareholders of both the transferor companies are to be discharged by issuing Equity shares of ₹ 10 each of the new company at a premium of ₹ 5 per share.*

Amalgamation is in the nature of purchase.

[Answer: Value of equity shares issued to System Ltd. ₹ 1,98,500 and to HRD Ltd. ₹ 1,78,500
Cash paid for fraction of shares = ₹ 1,98,500 less ₹ 1,98,495 = ₹ 5 to System Ltd.
Cash paid for fraction of shares = ₹ 25,000 less ₹ 24,990 = ₹ 10 to HRD Ltd.
Total of M/s Intranet balance sheet as at 1.4.2017 ₹ 5,64,985]

Question 4

The Balance Sheet of Munna Ltd as on 31st March, 2017 is as follows:

Liabilities	₹	*Assets*	₹
Authorised and issued Share capital		*Goodwill*	*2,00,000*

20,000 equity shares of ₹ 100 each, fully paid	*20,00,000*	*Plant & Machinery*	*18,00,000*
10,000, 7% Preference shares of ₹ 100 each	*10,00,000*	*Inventory*	*3,00,000*
Trade payables	*7,00,000*	*Trade receivables*	*7,50,000*
Bank overdraft	*3,00,000*	*Cash*	*1,50,000*
		Preliminary expenses	*1,00,000*
		Profit and Loss Account	*7,00,000*
	40,00,000		*40,00,000*

Additional Information: *Two years' preference share dividend is in arrears. The company had bad time during the last two years and hopes for better business in future, earning profit and paying dividend, provided the capital base is reduced.*

An internal reconstruction scheme, agreed to by all concerned, is as follows:

(i) Trade payables agreed to forego 50% of their claim.

(ii) Preference shareholders withdrew arrear dividend claim. They also agreed to lower down their capital claim by 20% by reducing nominal value in consideration of 9% dividend effective after reconstruction, in case equity shareholder's loss exceeded 50% on the application of the scheme.

(iii) Bank has agreed to convert overdraft into term loan to the extent required for making current ratio to 2:1.

(iv) Revalued amount for plant and machinery was accepted as ₹ 15,00,000.

(v) Trade receivables to the extent of ₹ 4,00,000 were considered as good.

(vi) Equity shares shall be exchanged for the same number of equity shares at a revised denomination as required after the reconstruction.

You are required to show the following:

(a) Total loss to be borne by the equity and preference shareholders for the reconstruction.

(b) Share of loss to the individual class of shareholders.

(c) New structure of share capital after reconstruction.

(d) Working capital of the reconstructed company, and

(e) A Performa Balance Sheet after reconstruction.

[Answer: Loss to be borne by Equity and Preference Shareholders ₹ 14,40,000; New structure of share capital after reorganization ₹ 17,00,000; Working capital of the reorganized company ₹ 4,25,000; Balance Sheet (total) of Munna Ltd. (and reduced) ₹ 23,50,000]

5

Consolidated Financial Statements of Group Companies

BASIC CONCEPTS

- Section 2 (46) and Section 2 (87)* of Companies Act, 2013 give the following definitions of Holding and Subsidiary Company:

  "holding company", in relation to one or more other companies, means a company of which such companies are subsidiary companies;

  "subsidiary company" or "subsidiary", in relation to any other company (that is to say the holding company), means a company in which the holding company—

  (i) controls the composition of the Board of Directors; or

  (ii) exercises or controls more than one-half of the total share capital either at its own or together with one or more of its subsidiary companies: Provided that such class or classes of holding companies as may be prescribed shall not have layers of subsidiaries beyond such numbers as may be prescribed.

  Explanation—For the purposes of this clause,—

  (a) a company shall be deemed to be a subsidiary company of the holding company even if the control referred to in sub-clause (i) or sub-clause (ii) is of another subsidiary company of the holding company;

  (b) the composition of a company's Board of Directors shall be deemed to be controlled by another company if that other company by exercise of some power exercisable by it at its discretion can appoint or remove all or a majority of the directors;

  (c) the expression "company" includes any body corporate.

  'Total share capital', as defined in section 2(87) (ii) above, has been further clarified by the Rule 2(1)(r) of the Companies (Specification of Definitions Details) Rules, 2014. As per the Rule, total share capital includes

  (a) paid up equity share capital

  (b) convertible preference share capital.

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* Erstwhile Section 4(1) of the Companies Act, 1956.

- In a wholly owned subsidiary, there is no minority interest because all the shares with voting rights are held by the holding company.
- Consolidated financial statements are prepared and presented by a parent/holding enterprise to provide financial information about a parent and its subsidiary(ies) as a single economic entity.
- **Distinction** must be made from the point of view of the holding company, between revenue and capital profit of the subsidiary. In the absence of information, profits of a year may be treated as accruing from day to day

Consolidation procedures

Rule 6 of the Companies (Accounts) Rules, 2014 states that the consolidation of financial statements of the company shall be made in accordance with the provisions of Schedule III of the Act and the applicable accounting standards.

AS 21 lays down the procedure for consolidation of financial statements of subsidiaries with the holding companies.

In preparing the consolidated financial statements, the following steps are taken:

- the carrying amount of the parent's investment in each subsidiary and the parent's portion of equity of each subsidiary are eliminated.
- in case cost of acquisition exceeds or is less than the acquirer's interest, goodwill or capital reserve is calculated retrospectively.
- intragroup transactions, including sales, expenses and dividends, are eliminated, in full;
- unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full;
- unrealised losses resulting from intragroup transactions that are deducted in arriving at the carrying amount of assets are also eliminated unless cost cannot be recovered;
- minority interest in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group in order to arrive at the net income attributable to the owners of the parent; and
- minority interests in the net assets of consolidated subsidiaries are identified and presented in the consolidated balance sheet separately from liabilities and the parent shareholders' equity.
- if the controlling interest was acquired during the course of a year, profit for that year must be apportioned into the pre-acquisition and post-acquisition portions, on the basis of time in the absence of information on the point.
- the financial statements of the parent and its subsidiaries are combined on a line by line basis by adding together like items of assets, liabilities, equity, income and expenses.
- dividend received from a subsidiary company, must be distinguished between the part received out of capital profits and that out of revenue profits - the former is credited to

Investment Account, it being a capital receipt, and the latter is adjusted as revenue income for being credited to the Profit & Loss Account.

- in respect of such goods not yet sold, the unrealised profits are to be eliminated in full. This may be done by creating a reserve in respect of total unrealised profit which has not yet been realised.
- also, unrealised losses resulting from intragroup transactions should also be eliminated unless cost cannot be recovered.

Preparation of Consolidated Profit and Loss Account

- All the revenue items are to be added on line by line basis and from the consolidated revenue items inter-company transactions should be eliminated.
- If there remains any unrealised profit in the inventory of good, of any of the Group Company, such unrealised profit is to be eliminated from the value of inventory to arrive at the consolidated profit.

Preparation of Consolidated Cash Flow Statement

All the items of Cash flow from operating activities, investing activities and financing activities are to be added on line by line basis and from the consolidated items, inter-company transactions should be eliminated.

Treatment of Investment in Associates in Consolidated Financial Statements

Section 129(3) of the Companies Act, 2013 states that those companies which do not have any subsidiary but have one or more associates or joint ventures or both, have also to prepare Consolidated Financial Statements.

An enterprise should account for investments in associates in the consolidated financial statements in accordance with the Accounting Standard (AS) 23.

Accounting for Associates (AS 23)

AS 23 suggests equity method of accounting for investments in associates.

Under equity method The following procedure should be followed:

- **Investment is initially recorded at cost.** Subsequently, the carrying amount is increased on the basis of share of profit or decreased on the basis of share of loss in the associate.
- Step (1): Find out value of investments on the basis of proportionate value of net assets of the investee;
- Step (2): Find out goodwill or capital reserve arising out of the purchase consideration.
  - If the purchase price is above the value of investments determined in step (1) then there is goodwill and
  - if the purchase price is less than the value of the investments determined in step (1) then there is capital reserve.

- Step (3): Goodwill or capital reserve as determined in step (2) should be included in the carrying amount of the investments with a separate disclosure. On the contrary, investments are recognised at purchase price as per AS 13 without disclosing goodwill/capital reserve.

  DISCLOSURE-Goodwill/capital reserve can be disclosed within bracket below the "Investments in Associates" in the following style and accumulated income which was not earlier recognized should be added to value of investments for first time consolidation with corresponding credit to consolidated reserve.

Equity method is not applicable

(1) when an investment is acquired for the purpose of disposal in the near future, i.e., as short term investments; and

(2) there is severe long term restriction on fund transfer by the associate to the investor. In these two cases AS 13 should be applied.

Treatment of Investment in Joint Ventures in Consolidated Financial Statements (AS 27)

AS 27 identifies three broad types of Joint Ventures- jointly controlled operations, jointly controlled assets and jointly controlled entities.

Jointly Controlled Operations

In respect of its interests in jointly controlled operations, a venturer should recognise in its separate financial statements and consequently in its consolidated financial statements:

(a) the assets that it controls and the liabilities that it incurs; and

(b) the expenses that it incurs and its share of the income that it earns from the joint venture.

Jointly Controlled Assets

In respect of its interest in jointly controlled assets, a venturer should recognise, in its separate financial statements, and consequently in its consolidated financial statements:

(a) its share of the jointly controlled assets, classified according to the nature of the assets;

(b) any liabilities which it has incurred;

(c) its share of any liabilities incurred jointly with the other venturers in relation to the joint venture;

(d) any income from the sale or use of its share of the output of the joint venture, together with its share of any expenses incurred by the joint venture; and

(e) any expenses which it has incurred in respect of its interest in the joint venture.

Jointly Controlled Entities: A jointly controlled entity maintains its own accounting records and prepares and presents financial statements in the same way as other enterprises in conformity with the requirements of AS 27 applicable to that jointly controlled entity.

Separate Financial Statements of a Venturer

In a venturer's separate financial statements, interest in a jointly controlled entity should be accounted for as an investment in accordance with Accounting Standard (AS) 13.

Consolidated Financial Statements of a Venturer

In its consolidated financial statements, a venturer should report its interest in a jointly controlled entity using proportionate consolidation except

(a) an interest in a jointly controlled entity which is acquired and held exclusively with a view to its subsequent disposal in the near future; and

(b) an interest in a jointly controlled entity which operates under severe long-term restrictions that significantly impair its ability to transfer funds to the venturer.

Problems involving one Subsidiary

Question 1

On 31st March, 2017, the abridged Balance Sheets of H Ltd. and S Ltd. stood as follows:

	H Ltd. (₹ in 000's)	S Ltd. (₹ in 000's)
Liabilities		
Equity Share Capital – Authorised	5,000	3,000
Issued and subscribed in Equity Shares of ₹ 10 each fully paid	4,000	2,400
General Reserve	928	690
Profit and Loss Account	1,305	810
Trade payables	611	507
Provision for Taxation	220	180
Other Provisions	65	17
	7,129	4,604
Assets:		
Plant and Machinery	2,541	2,450
Furniture and Fittings	615	298
Investment in the Equity Shares of S Ltd.	1,500	–
Inventory	983	786
Trade receivables	820	778
Cash and Bank Balances	410	102
Sundry Advances	260	190
	7,129	4,604

Following Additional Information is available:

(a) H Ltd. purchased 90 thousand Equity Shares in S Ltd. on 1st April, 2016 at which date the following balances stood in the books of S Ltd.

General Reserve ₹ 1,500 thousand; Profit and Loss Account ₹ 633 thousand.

(b) On 14th July, 2016 S Ltd. declared a dividend of 20% out of pre-acquisition profits and paid corporate dividend tax (including surcharge) at 17.304%. H Ltd. credited the dividend received to its Profit and Loss Account.

(c) On 1st November, 2016, S Ltd. issued 3 fully paid Equity Shares of ₹ 10 each, for every 5 shares held as bonus shares out of pre-acquisition General Reserve.

(d) On 31st March, 2017, the Inventory of S Ltd. included goods purchased for ₹ 50 thousand from H Ltd., which had made a profit of 25% on Cost.

(e) Details of Trade payables and Trade receivables:

	H Ltd. (₹ in 000's)	S Ltd. (₹ in 000's)
Trade payables		
Bills Payable	124	80
Sundry creditors	487	427
	611	507
Trade receivables		
Debtors	700	683
Bills Receivables	120	95
	820	778

Prepare a consolidated Balance Sheet as on 31st March, 2017.

Answer

Consolidated Balance Sheet of H Ltd. with its subsidiary S Ltd. as on 31st March, 2017

Particulars	Note No.	(₹ in 000's)
I. Equity and Liabilities		
(1) **Shareholder's Funds**		
(a) Share Capital	1	4,000
(b) Reserves and Surplus	2	3,063
(2) **Minority Interest (W.N.6)**		1,560
(3) **Current Liabilities**		
Trade payables	3	1,118

	Short term provisions	4	482
	Total		10,223
II.	**Assets**		
	(1) **Non-current assets**		
	Fixed assets		
	Tangible assets	5	5,904
	(2) **Current assets**		
	(a) Inventories	6	1,759
	(b) Trade receivables	7	1,598
	(c) Cash and cash equivalents	8	512
	(d) Short term loans and advances	9	450
	Total		10,223

Notes to Accounts

					(₹ in 000's)	(₹ in 000's)
1.	Share Capital					
	Authorised share capital					
	5 lakhs equity shares of ₹ 10 each					5,000
	Issued, Subscribed and Paid up					
	4 lakhs equity shares of ₹ 10 each fully paid					4,000
2.	Reserves and surplus					
	Capital Reserve (Note 5)				643.20	
	General Reserve				928	
	Profit and Loss Account:					
		H Ltd.		₹1,305		
	Add: Share in	S Ltd		₹376.80		
				₹1,681.80		
	Less: Dividend wrongly credited			₹ (180)		
				₹1,501.80		
	Less: Unrealised profit (50 X 1/5)			₹ (10)	1,491.80	3,063
3.	Trade payables					
		H Ltd.			611	
		S Ltd.			507	1,118
4.	Short –term provisions					
	Provision for Taxation	H Ltd.		₹ 220		
		S Ltd.		₹ 180	400	

	Other Provisions	H Ltd	₹ 65		
		S Ltd.	₹ 17	82	482
5.	Tangible Assets				
	Plant and Machinery				
		H Ltd.	₹ 2,541		
		S Ltd.	₹ 2,450	4,991	
	Furniture and fittings				
		H Ltd.	₹ 615		
		S Ltd.	₹ 298	913	5,904
6.	Inventories				
	Inventory	H Ltd.	₹ 983		
		S Ltd.	₹ 786	1,769	
	Less: Unrealised profit (₹ 50 x 1/5)			(10)	1,759
7.	Trade receivables				
		H Ltd.		820	
		S Ltd.		778	1,598
8.	Cash and cash equivalents				
	Cash and Bank Balances	H Ltd		410	
		S Ltd.		102	512
9.	Short term loans and advances				
	Sundry Advances	H Ltd.		260	
		S Ltd.		190	450

Working Notes:

Share holding pattern

Particulars	Number of Shares	% of holding
a. S Ltd.		
(i) Purchased on 01.04.2016	90,000	
(ii) Bonus Issue (90,000/5 x 3)	54,000	
Total	1,44,000	60%
b. Minority Interest	96,000	40%

1. S Ltd. General Reserve

	(₹ in 000)		(₹ in 000)
To Bonus to equity shareholders	900	By Balance b/d	1,500
		By Profit and Loss A/c	

$\left(\frac{2,400 \times 3}{8}\right)$ To Balance c/d	690 1,590	(Balancing figure)	90 1,590

2. S Ltd.'s Profit and Loss Account

	(₹ in 000)		(₹ in 000)
To General Reserve	90	By Balance b/d	633
To Dividend paid on 14.7.2016 $\frac{1,500 \times 20}{100}$	300	By Net Profit for the year (Balancing figure)	628*
To Corporate Dividend Tax (17.304% of 353) (Refer W.N. 7)	61		
To Balance c/d	810		
	1,261		1,261

* Out of ₹ 6,28,000 profit for the year, ₹ 90,000 has been transferred to reserves by S Ltd.

3. Distribution of Revenue Profits

	₹ in '000
Revenue Profit as above	628.00
Share of H Ltd. (60%)	376.80
Share of Minority shareholders (628 – 376.80)	251.20

4. Computation of Capital Profits

		₹ in 000	₹ in 000
General Reserve on the date of acquisition			1,500
Less: Bonus issue of shares			(900)
			600
Profit and Loss Account balance on the date of acquisition		633	
Less: Dividends paid	₹ 300		
Corporate tax paid	₹ 61	(361)	272
			872
Share of H Ltd. (60%)			523.20
Share of Minority shareholders			348.80

5. Computation of Capital Reserve

		₹ in '000
60% of share capital of S Ltd.		1,440

Add: Share of H Ltd. in the capital profits as in working note (4)		523.20
		1,963.20
Less: Investments in S Ltd.	1,500	
Less: Dividends received out of pre- acquisition profits $\frac{₹\ 300 \times 60}{100}$	(180)	(1,320)
		643.20

6. Calculation of Minority Interest

	₹ in '000
40% of share capital of S Ltd.	960.00
Add: Share of Revenue Profits (Note 3)	251.20
Share of Capital Profits (Note 4)	348.80
	1,560.00

7. Calculation of grossing up of dividend

	₹ in '000s
Dividend distributed by S Ltd. (1500 x 20)/100	300
Add: Increase for the purpose of grossing up of dividend [{15/(100-15)} x 300]	52.94
	352.94 or 353.00 (approx.)
Dividend distribution tax @ 17.304% (353 x 17.304%) = 61.08 or	61 (approx.)

Question 2

On 31st March, 2011, P Ltd. acquired 1,05,000 shares of Q Ltd. for ₹ 12,00,000. The Balance Sheet of Q Ltd. on that date was as under:

Liabilities	*₹*	*Assets*	*₹*
1,50,000 equity shares of ₹ 10 each fully paid	*15,00,000*	*Fixed Assets*	*10,50,000*
		Current Assets	*6,45,000*
Pre-incorporation profits	*30,000*		
Profit and Loss Account	*60,000*		
Trade payables	*1,05,000*		
	16,95,000		*16,95,000*

On 31st March, 2017 the summarized Balance Sheets of two companies were as follows:

Liabilities	P Ltd. ₹	Q Ltd. ₹	Assets	P Ltd. ₹	Q Ltd. ₹
Equity shares of ₹ 10 each fully paid (before bonus issue)	45,00,000	15,00,000	Fixed Assets	79,20,000	23,10,000
			1,05,000 Equity shares in Q Ltd. at cost	12,00,000	–
Securities Premium	9,00,000	–	Current Assets	44,10,000	17,55,000
Pre-incorporation profits	–	30,000			
General Reserve	60,00,000	19,05,000			
Profit and Loss Account	15,75,000	4,20,000			
Trade payables	5,55,000	2,10,000			
	1,35,30,000	40,65,000		1,35,30,000	40,65,000

Directors of Q Ltd. made bonus issue on 31.3.2017 in the ratio of one equity share of ₹ 10 each fully paid for every two equity shares held on that date.

Calculate as on 31st March, 2017 (i) Cost of Control/Capital Reserve; (ii) Minority Interest; (iii) Consolidated Profit and Loss Account in each of the following cases:

(i) Before issue of bonus shares.

(ii) Immediately after issue of bonus shares.

It may be assumed that bonus shares were issued out of post-acquisition profits by using General Reserve.

Prepare a Consolidated Balance Sheet after the bonus issue.

Answer

Consolidated Balance Sheet of P Ltd. and its subsidiary Q Ltd.
as on 31st March, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	45,00,000
(b) Reserves and Surplus	2	99,73,500
(2) **Minority Interest (W.N)**		11,56,500
(3) **Current Liabilities**		
Trade payables (5,55,000+2,10,000)		7,65,000
Total		1,63,95,000

II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangibles assets (79,20,000 + 23,10,000)		1,02,30,000
(2) **Current assets** (44,10,000+17,55,000)		61,65,000
Total		1,63,95,000

Notes to Accounts

		(₹ in 000's)	(₹ in 000's)
1.	Share Capital		
	Shares of ₹ 10 each		45,00,000
2.	Reserves and surplus		
	Securities Premium	9,00,000	
	Capital Reserve	4,38,000	
	General Reserve	60,00,000	
	Profit and Loss Account	26,35,500	99,73,500

Shareholding pattern

Particulars	Number of Shares	% of holding
a. P Ltd.		
(i) Purchased on 31.03.2011	1,05,000	
(ii) Bonus Issue (1,05,000/2)	52,500	
Total	1,57,500	70%
b. Minority Interest	67,500	30%

(i) Before issue of bonus shares

(i)	Cost of control/capital reserve	₹	₹
	Investment in Q Ltd.		12,00,000
	Less: Face value of investments	10,50,000	
	Capital profits (W.N.)	63,000	(11,13,000)
	Cost of control		87,000
(ii)	Minority Interest		₹
	Share Capital		4,50,000
	Capital profits (W.N.)		27,000
	Revenue profits (W.N.)		6,79,500
			11,56,500

(iii)	Consolidated profit and loss account – P Ltd.		₹
	Balance		15,75,000
	Add: Share in revenue profits of Q Ltd.(W.N.)		15,85,500
			31,60,500

(ii) Immediately after issue of bonus shares

(i)	Cost of control/capital reserve	₹	₹
	Face value of investments (₹ 10,50,000 +₹ 5,25,000)	15,75,000	
	Capital Profits (W.N.)	63,000	16,38,000
	Less: Investment in Q Ltd.		(12,00,000)
	Capital reserve		4,38,000
(ii)	Minority Interest		₹
	Share Capital (₹ 4,50,000 + ₹ 2,25,000)		6,75,000
	Capital Profits (W.N.)		27,000
	Revenue Profits (W.N.)		4,54,500
			11,56,500
(iii)	Consolidated Profit and Loss Account – P td.		₹
	Balance		15,75,000
	Add: Share in revenue profits of Q Ltd. (W.N.)		10,60,500
			26,35,500

Working Note:

Analysis of Profits of Q Ltd.

	Capital Profits (Before and after issue of bonus shares) ₹	*Revenue Profits*	
		Before Bonus Issue ₹	*After Bonus Issue* ₹
Pre-incorporation profits	30,000		
Profit and loss account on 31.3.2011	60,000		
	90,000		
General reserve*		19,05,000	19,05,000
Less: Bonus shares			(7,50,000)
			11,55,000

Profit for period of 1st April, 2012 to 31st March, 2017 (₹ 4,20,000 – ₹ 60,000)		3,60,000	3,60,000
		22,65,000	15,15,000
P Ltd.'s share (70%)	63,000	15,85,500	10,60,500
Minority's share (30%)	27,000	6,79,500	4,54,500

*Share of P Ltd. in General reserve has been adjusted in Consolidated Profit and Loss Account.

Question 3

On 31st March, 2017 the summarized Balance Sheets of H Ltd. and its subsidiary S Ltd. stood as follows:

Liabilities	*H Ltd.*	*S Ltd.*
	₹ in lakhs	*₹ in lakhs*
Share Capital:		
Authorised	*15,000*	*6,000*
Issued and Subscribed:		
Equity Shares of ₹ 10 each, fully paid up	*12,000*	*4,800*
General Reserve	*2,784*	*1,380*
Profit and Loss Account	*2,715*	*1,620*
Bills Payable	*372*	*160*
Trade Payables	*1,461*	*854*
Provision for Taxation	*855*	*394*
Dividend payable	*1,200*	*–*
	21,387	*9,208*
Assets	*H Ltd.*	*S Ltd.*
	₹ in lakhs	*₹ in lakhs*
Land and Buildings	*2,718*	*–*
Plant and Machinery	*4,905*	*4,900*
Furniture and Fittings	*1,845*	*586*
Investments in shares in S Ltd.	*3,000*	*–*
Stock	*3,949*	*1,956*
Trade Receivables	*2,600*	*1,363*
Cash and Bank Balances	*1,490*	*204*
Bills Receivable	*360*	*199*
Sundry Advances	*520*	*–*
	21,387	*9,208*

The following information is also provided to you:

(a) *H Ltd. purchased 180 lakh shares in S Ltd. on 1st April, 2016 when the balances to General Reserve and Profit and Loss Account of S Ltd. stood at ₹ 3,000 lakh and ₹ 1,200 lakh respectively.*

(b) *On 31st March, 2016, S Ltd. declared a dividend @ 20% for the year ended 31st March, 2016. H Ltd. credited the dividend received by it to its Profit and Loss Account.*

(c) *On 1st January, 2017 S Ltd. issued 3 fully paid-up bonus shares for every 5 shares held out of balances to its general reserve as on 31st March, 2016.*

(d) *On 31st March, 2017 all the bills payable in S Ltd.'s balance sheet were acceptances in favour of H Ltd. But on that date, H Ltd. held only ₹ 45 lakh of these acceptances in hand, the rest having been endorsed in favour of its trade payables.*

(e) *On 31st March, 2017, S Ltd.'s inventory included goods which it had purchased for ₹ 100 lakh from H Ltd. which made a profit @ 25% on cost.*

Prepare a Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as at 31st March, 2017 bearing in mind the requirements of AS 21.

Answer

Consolidated Balance Sheet of H Ltd. and its subsidiary S Ltd. as on 31st March, 2017

Particulars	*Note No.*	*(₹ in Lacs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	12,000
(b) Reserves and Surplus	2	7,159
(2) **Minority Interest [W.N.6]**		3,120
(3) **Current Liabilities**		
(a) Trade payables	3	2,315
(b) Short term provisions	4	1,249
(c) Other current liabilities	5	1,687
Total		27,530
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	6	14,954

(2)	**Current assets**		
	(a) Inventories	7	5,885
	(b) Trade receivables	8	3,963
	(c) Cash and cash equivalents	10	1,694
	(d) Short term loans and advances	11	520
	(e) Other current assets	9	514
	Total		27,530

Notes to Accounts

				(₹ in lacs)	(₹ in lacs)
1.	Share Capital				
	Authorised				15,000
	Issued and Subscribed:				
	Equity shares of ₹ 10 each, fully paid up				12,000
2.	Reserves and surplus				
	Capital Reserve (Note 5)			1,320	
	General Reserve (₹2,784 + 108)			2,892	
	Profit and Loss Account:				
	H Ltd.		₹ 2,715		
	Less: Dividend wrongly credited	₹ 360			
	Unrealised Profit	₹ 20	(₹ 380)		
			₹ 2,335		
	Add: Share in S Ltd.'s Revenue profits		₹ 612	2,947	7,159
3.	Trade payables				
	H Ltd.			1,461	
	S Ltd.			854	2,315
4.	Short term provisions				
	Provision for Taxation				
	H Ltd.			855	
	S Ltd.			394	1,249
5.	Other current liabilities				
	Bills Payable				
	H Ltd.			₹ 372	
	S Ltd.			₹ 160	

			₹ 532	
	Less: Mutual owing		₹ (45)	487
	Dividend payable			
	H Ltd.			1,200
				1,687
6.	Tangible assets			
	Land and Buildings			
	H Ltd.		2,718	
	Plant and Machinery			
	H Ltd.	₹ 4,905		
	S Ltd.	₹ 4,900	9,805	
	Furniture and Fittings			
	H Ltd.	₹ 1,845		
	S Ltd.	₹ 586	2,431	14,954
7.	Inventories			
	Stock			
	H Ltd.		3,949	
	S Ltd.		1,956	
			5,905	
	Less: Unrealised profit		(20)	5,885
8.	Trade receivables			
	H Ltd.	₹ 2,600		
	S Ltd.	₹ 1,363		3,963
9.	Other current assets			
	Bills Receivable			
	H Ltd.	₹ 360		
	S Ltd.	₹ 199		
		₹ 559		
	Less: Mutual Owing	₹ (45)		514
10.	Cash and cash equivalents			
	Cash and Bank Balances			
	H Ltd.		1,490	
	S Ltd.		204	1,694

11.	Short term loans and advances Sundry Advances H Ltd.		520

Working Notes:

Share holding pattern of S Ltd.

Shares as on 31.03.2017 (Includes bonus shares issued on 01.01.2017)	480 lakh shares (4,800 lakhs/ ₹ 10)
H Ltd's holding as on 01.04.2016	180 lakhs
Add : Bonus received on 01.01.2017	108 lakhs (180 / 5 × 3)
Total H Ltd's holding as on 31.03.2017	288 lakhs i.e. 60 % [288 / 480 × 100]
Minority Shareholding	40%

1. S Ltd.'s General Reserve Account

	₹ in lakhs		*₹ in lakhs*
To Bonus to Equity Shareholders	1,800	By Balance b/d	3,000
To Balance c/d	1,380	By Profit and Loss A/c (Balancing figure)	180
	3,180		3,180

2. S Ltd.'s Profit and Loss Account

	₹ in lakhs		*₹ in lakhs*
To General Reserve [WN 1]	180	By Balance b/d	1,200
To Dividend paid (20% on ₹3,000 lakhs)	600	By Net Profit for the year* (Balancing figure)	1,200
To Balance c/d	1,620		
	2,400		2,400

*Out of ₹ 1,200 lakhs profit for the year, ₹ 180 lakhs has been transferred to reserves.

3. Distribution of Revenue profits

	₹ in lakhs
Revenue profits (W. N. 2)	1,200
Less: Share of H Ltd. 60% (General Reserve ₹ 108 + Profit and Loss Account ₹ 612)	(720)
Share of Minority Shareholders (40%)	480

Note: The question can also be solved by taking ₹ 1,080 lakhs as post acquisition Profit and Loss balance and ₹ 180 lakhs as post acquisition General Reserve balance. The final answer will be same.

4. Calculation of Capital Profits

	₹ in lakhs
General Reserve on the date of acquisition less bonus shares (₹ 3,000 – ₹ 1,800)	1,200
Profit and loss account on the date of acquisition less dividend paid (₹ 1,200 – ₹ 600)	600
	1,800

H Ltd.'s share = 60% of ₹ 1,800 lakhs = ₹ 1,080 lakhs

Minority interest = ₹ 1,800 – ₹ 1,080 = ₹ 720 lakhs

5. Calculation of capital reserve

	₹ in lakhs
Paid up value of shares held (60% of ₹4,800)	2,880
Add: Share in capital profits [WN 4]	1,080
	3,960
Less: Cost of shares less dividend received (₹ 3,000 – ₹ 360)	(2,640)
Capital reserve	1,320

6. Calculation of Minority Interest

	₹ in lakhs
40% of share capital (40% of ₹ 4,800)	1,920
Add: Share in revenue profits [WN 3]	480
Share in capital profits [WN 4]	720
	3,120

7. Unrealised profit in respect of inventory

$$₹\ 100 \text{ lakhs} \times \frac{25}{125} = ₹\ 20 \text{ lakhs}$$

Question 4

The following are the summarised Balance Sheets of PD Co. Ltd. and SD Co. Ltd. as on 31.3.2017:

Liabilities	PD Co. Ltd. ₹	SD Co. Ltd. ₹
Share Capital:		
Authorised	70,00,000	30,00,000
Issued and Subscribed Capital		
Equity shares of ₹ 10 each fully paid	50,00,000	20,00,000
Capital Reserve	5,00,000	3,10,000
Revenue Reserve	8,50,000	75,000
Profit and Loss Account	4,00,000	2,80,000
Trade payables	3,50,000	2,35,000
	71,00,000	29,00,000
Assets	**PD Co. Ltd. ₹**	**SD Co. Ltd. ₹**
Land and Buildings	20,00,000	15,20,000
Plant and Machinery	20,00,000	8,00,000
Furniture	5,00,000	1,60,000
Investments	16,10,000	–
Inventory	3,40,000	1,00,000
Trade receivables	4,10,000	2,40,000
Bank	2,40,000	80,000
	71,00,000	29,00,000

PD Ltd. acquired 80% shares of SD Ltd. on 30.09.2016 at a cost of ₹ 18,10,000. On 1.10.2016 SD Ltd. declared and paid dividend on Equity Shares. PD Ltd. appropriately adjusted its share of dividend in Investment Account.

On 1.4.2016, the Capital Reserve and Profit and Loss Account stood in the books of SD Ltd. at ₹ 50,000 and ₹ 2,75,000 respectively.

Land and Buildings standing in the books of SD Ltd. at ₹ 16,00,000 on 1.4.2016, revalued at ₹ 20,00,000 on 1.10.2016. Furniture, which stood in the books at ₹ 2,00,000 on 1.4.2016 revalued at ₹ 1,50,000 on 1.10.2016. In both the cases the effects have not yet been given in the books.

SD Ltd. bought an item of machinery from PD Ltd. on hire-purchase basis. The following are the balances in respect of this machinery in the books on 31.03.2017 (assuming that the total of instalment due & not due comprises the value of machinery bought by SD Ltd. from PD Ltd):

	₹
Instalment due	*20,000*
Instalment not due	*8,000*

The above items stood included under appropriate heads in Balance Sheet. Hire-purchase inventory reserve ₹ 1,600.

Other details of Trade payables and Trade receivables:

	H Ltd. (₹ in 000's)	*S Ltd. (₹ in 000's)*
Trade payables		
Bills Payable	*1,00,000*	*10,000*
Sundry creditors	*2,50,000*	*2,25,000*
	3,50,000	*2,35,000*
Trade receivables		
Debtors	*3,60,000*	*2,00,000*
Bills Receivables	*50,000*	*40,000*
	4,10,000	*2,40,000*

Prepare a Consolidated Balance Sheet of PD Ltd. and its subsidiary SD Ltd. as at 31.03.2017, complying with the requirements of AS 21.

Answer

Consolidated Balance Sheet of PD Co. Ltd. with its subsidiary SD Co. Ltd. as on 31st March, 2017

Particulars	Note No.	(₹)
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	50,00,000
(b) Reserves and Surplus	2	25,90,400
(2) **Minority interest (W.N. 5)**		6,14,000
(3) **Current Liabilities**		
Trade payables	3	5,57,000
Total		87,61,400
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		

	Tangible assets	4	73,79,400
(2)	**Current assets**		
	(a) Inventories	5	4,32,000
	(b) Trade receivables	6	6,30,000
	(c) Cash and cash equivalents	7	3,20,000
	Total		87,61,400

Notes to Accounts

			₹	₹
1.	Share Capital			
	Authorised			70,00,000
	Issued and subscribed			
	Equity shares of ₹10 each, fully paid up			50,00,000
2.	Reserves and surplus			
	Capital reserve (W.N.8)		12,18,000	
	Revenue reserve (W.N. 9)		8,80,000	
	Profit and loss account (W.N. 10)		4,92,400	25,90,400
3.	Trade Payables			
	PD Ltd.		3,50,000	
	SD Ltd.		2,35,000	
			5,85,000	
	Less: Mutual hire purchase indebtedness		(28,000)	5,57,000
4.	Tangible Assets			
	Land and buildings			
	PD Ltd.	20,00,000		
	SD Ltd. (W.N. 2)	19,50,000	39,50,000	
	Plant and machinery			
	PD Ltd.	20,00,000		
	SD Ltd.	8,00,000		
		28,00,000		
	Less: Unrealised profit on hire purchase transaction	(5,600)	27,94,400	
	Furniture			

	PD Ltd.	5,00,000		
	SD Ltd. (W.N. 2)	1,35,000	6,35,000	73,79,400
5.	Inventories			
	PD Ltd.		3,40,000	
	SD Ltd.		1,00,000	
			4,40,000	
	Less: Hire purchase installment not due		(8,000)	4,32,000
6.	Trade receivables			
	PD Ltd.		4,10,000	
	SD Ltd.		2,40,000	
			6,50,000	
	Less: Hire purchase Instalment due		(20,000)	6,30,000
7.	Cash and cash equivalents			
	Bank Balances:			
	PD Ltd.		2,40,000	
	SD Ltd.		80,000	3,20,000

Working Notes:

1. Analysis of reserves and profits of SD Co. Ltd. as on 31.03.2017

		Pre-acquisition profit upto 30.09.2016 (Capital profits)	*Post-acquisition profits (1.10.2016 – 31.3.2017)*		
			Capital reserve	*Revenue reserve*	*Profit and loss account*
Capital reserve as on 31.3.2017	3,10,000				
Less: Balance as on 1.4.2016	(50,000)	50,000			
Created during the year	2,60,000	1,30,000	1,30,000		
Revenue reserve as on 31.3.2017	75,000				
Less: Balance as on 1.4.2016	–				
Created during the year	75,000	37,500		37,500	
Profit and loss account as on 31.3.2017	2,80,000				
Add: Dividend paid on 1.10.2016 (out of pre-acquisition profits)	2,50,000				

WN 11					
	5,30,000				
Less: balance as on 1.4.2016	(2,75,000)				
Earned during the year	2,55,000	1,27,500			1,27,500
Profit as on 1.4.2016	2,75,000				
Less: Dividend paid WN 11]	(2,50,000)				
Balance of pre-acquisition profit as on 31.3.2017	25,000	25,000			
Revaluation as on 1.10.2016:					
Profit on land and buildings (W.N. 2)		4,40,000			
Loss on furniture (W.N.2)		(30,000)			
Difference in depreciation (for 6 months) due to revaluation:					
Short depreciation on land and building (W.N. 3)					(10,000)
Excess depreciation on furniture (W.N. 3)					5,000
Total		7,80,000	1,30,000	37,500	1,22,500
Minority Interest (20%)		1,56,000	26,000	7,500	24,500
Share of PD Co. Ltd. (80%)		6,24,000	1,04,000	30,000	98,000

2. Profit or loss on revaluation of assets in the books of SD Ltd. and their book values as on 31.3.2017

	₹
Land and buildings	
Book value as on 1.4.2016	16,00,000
Less: Depreciation at 5% [WN 12] p.a. for 6 months	(40,000)
	15,60,000
Revalued on 1.10.2016	20,00,000
Profit on revaluation	4,40,000
Value as per balance sheet on 31.3.2017	15,20,000
Add: Profit on revaluation	4,40,000
	19,60,000
Less: Short Depreciation (W.N. 3)	(10,000)
Value as on 31.3.2017	19,50,000
Furniture	
Book value as on 1.4.2016	2,00,000

Less: Depreciation @ 20% [WN 12] p.a. for 6 months	(20,000)
	1,80,000
Revalued on 1.10.2016	1,50,000
Loss on revaluation	30,000
Value as per balance sheet on 31.3.2017	1,60,000
Less: Loss on revaluation	(30,000)
	1,30,000
Add: Excess depreciation written back (W.N. 3)	5,000
Value as on 31.3.2017	1,35,000

3. Calculation of short/excess depreciation

	Building	*Furniture*
Revalued figure as on 1.10.2016	20,00,000	1,50,000
Rate of depreciation [WN 12]	5% p.a.	20% p.a.
Depreciation for 6 months on revalued figure (1.10.2016 to 31.3.2017)	50,000	15,000
Depreciation already provided	40,000	20,000
Difference [(short)/excess]	(10,000)	5,000

4. Calculation of cost of control

	₹
Share capital in SD Ltd.	16,00,000
Add: Capital profit	6,24,000
	22,24,000
Less: Cost of Investments	(16,10,000)
Capital Reserve	6,14,000

5. Calculation of minority interest [20%]

	₹	₹
Share capital		4,00,000
Capital (pre-acquisition) profits [WN 1]		1,56,000
Revenue (post-acquisition) profits: [WN 1]		
Capital Reserve (20% of 1,30,000)	26,000	
Revenue reserve	7,500	

Profit and loss	24,500	58,000
		6,14,000

6. Inventory reserve (plant and machinery)

Percentage of profit on hire purchase transaction

$$\frac{1,600 \times 100}{8,000} = 20\%$$

20% on ₹ 20,000 = ₹ 4,000

Total unrealised profit = ₹ 4,000 + ₹ 1,600 = ₹ 5,600

7. Elimination of mutual indebtedness

Elimination of mutual indebtedness in respect of sale of machinery on hire purchase basis will be made as under in the Consolidated Balance Sheet.

	Trade payables ₹	*Trade receivables* ₹	*Inventory* ₹	*Plant and machinery* ₹
Total (PD Ltd. and SD Ltd.)	4,75,000	5,60,000	4,40,000	28,00,000
Less: Instalment due	(20,000)	(20,000)	–	–
Less: Instalment not due	(8,000)	–	(8,000)	–
Less: Profit on plant purchased by SD Ltd. from PD Ltd. on hire purchase	–	–	–	(5,600)
	4,47,000	5,40,000	4,32,000	27,94,400

For consolidated balance sheet purpose, the unrealised profits will be eliminated by deducting ₹ 5,600 from Plant & Machinery and from profit and loss account.

8. Consolidated capital reserve as on 31.3.2017

	₹
Capital reserve of PD Ltd. as on 31.3.2017	5,00,000
Add: Share in post acquisition capital reserve of SD Ltd. (W.N. 1)	1,04,000
Add: Cost of control (W.N. 4)	6,14,000
	12,18,000

9. Consolidated revenue reserve as on 31.3.2017

	₹
Revenue reserve of PD Ltd. as on 31.3.2017	8,50,000

Add: Share in post acquisition revenue reserve of SD Ltd. (W.N. 1)	30,000
	8,80,000

10. Consolidated profit and loss account as on 31.3.2017

	₹
Profit and loss account balance of PD Ltd. as on 31.3.2017	4,00,000
Add: Share in post acquisition profit and loss account of SD Ltd. (W.N. 1)	98,000
Less: Unrealised profit on hire purchase	(5,600)
	4,92,400

11. Calculation of Dividend Paid

PD Ltd's Investment as on 30.09.2016 ₹ 18,10,000

PD Ltd's Investment as on 31.03.2017 ₹ 16,10,000

PD Ltd's share of dividend ₹ 2,00,000

(since it has credited the investment a/c on the receipt of dividend, the reduction in investment balance is due to dividend received)

Dividend declared and paid by SD Ltd will be ₹ 2,50,000 (₹ 2,00,000 / 80 %)

12 Calculation of Depreciation Rate

	Land & Building	Furniture
As on 01.04.2016 (a)	₹ 16,00,000	2,00,000
As on 31.03.2017 (b)	₹ 15,20,000	₹ 1,60,000
Depreciation (c)= (a)-(b)	₹ 80,000	₹ 40,000
Rate (c) / (a) X 100	5%	20%

Note: In the question, the balance of capital reserve and profit and loss account of SD Ltd., as on 1.4.2016 only has been given and not of revenue reserve. Hence, it has been assumed in the above solution that the revenue reserve is created during the year from current year's profits.

Question 5

War Limited purchased 48,000 shares in Peace Limited on 31st March 2015, at 50% premium over face value by issue of 8% Debentures at 20% premium. The Balance Sheets of War Limited and Peace Limited as on 31-03-2015, i.e., on the date of purchase were as under:

					(in ₹)
Liabilities	*War Ltd.*	*Peace Ltd.*	*Assets*	*War Ltd.*	*Peace Ltd.*
Share capital of ₹ 10 each	*10,50,000*	*6,00,000*	*Fixed Assets*	*6,50,000*	*2,00,000*

General Reserve	*1,20,000*	*40,000*	*Inventory in Trade*	*3,00,000*	*1,80,000*
Profit and Loss A/c	*80,000*	*-*	*Trade receivables*	*3,40,000*	*2,10,000*
Trade payables	*1,00,000*	*60,000*	*Cash in hand*	*60,000*	*30,000*
			Profit and Loss A/c	*-*	*80,000*
	13,50,000	*7,00,000*		*13,50,000*	*7,00,000*

(a) Particulars of War Limited:

(i) Profits made: 2015-2016 ₹ 1,60,000

2016-2017 ₹ 2,00,000

(ii) The above profit was made after charging depreciation of ₹ 60,000 and ₹ 40,000 respectively.

(iii) Out of profit shown above, every year ₹ 20,000 had been transferred to General Reserve.

(iv) 10% Dividend had been paid in both the years.

(v) It has been decided to write down investment to face value of shares in 10 years and to provide for share of loss to subsidiary.

(b) Particulars of Peace Limited:

The company incurred losses of ₹ 40,000 and ₹ 60,000 in 2015-2016 and 2016-2017 after charging depreciation of 10% p.a. on the book value of Fixed Assets as on 01-04-2015.

Prepare Consolidated Balance Sheet of War Limited and its subsidiary as at 31st March, 2017 as per requirement of Schedule III.

Answer

Consolidated Balance Sheet of War Ltd. and its subsidiary Peace Ltd.

as at 31st March, 2017

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	10,50,000
(b) Reserves and Surplus	2	3,42,000
(2) Minority Interest [W.N.6(b)]		92,000
(3) Non-current Liabilities		
Long-term borrowings	3	6,00,000
Total		20,84,000

II.	Assets		
	(1) Non-current assets		
	(a) Fixed assets	4	7,10,000
	(b) Intangible assets	5	2,24,000
	(2) Net current assets	6	11,50,000
	Total		20,84,000

Notes to Accounts

			₹
1.	Share Capital		
	Issued and Subscribed:		
	1,05,000 shares of ₹ 10 each fully paid up		10,50,000
2.	Reserves & surplus		
	Securities premium	1,20,000	
	General Reserve	1,60,000	
	Profit and Loss Account [W.N.6(d)]	62,000	3,42,000
3.	Long Term Borrowings		
	6,000, 8% Debentures of ₹ 100 each		6,00,000
4.	Tangible Assets		
	War Ltd. [W.N.3]	5,50,000	
	Peace Ltd. [W.N.3]	1,60,000	7,10,000
5.	Intangible assets		
	Goodwill [W.N.6(c)]		2,24,000
6.	Net current assets		
	War Ltd. [W.N.5]	8,50,000	
	Peace Ltd. [W.N.5]	3,00,000	11,50,000

Working Notes:

Percentage of shareholding of War Ltd. in Peace Ltd.:

48,000 shares out of 60,000 shares i.e $\frac{48,000}{60,000} \times 100 = 80\%$

1. Investment in Peace Ltd.

	₹
Face value of shares (48,000 shares x ₹ 10)	4,80,000
Premium (50%) over face value	2,40,000
Cost of investment	7,20,000

Acquired by issue of debentures at 20% premium:

	₹
8% Debentures	6,00,000
(Nominal value = 7,20,000/120 × 100)	
Add: Securities premium @ 20%	1,20,000
	7,20,000
Writing down of investment to face value in 10 years	
2015-2016 : 1/10 × 2,40,000	(24,000)
2016-2017: 1/10 × 2,40,000	(24,000)
Investment as on 31.3.2017	6,72,000

2. Balance of Profit and Loss Account for the year ended on 31st March, 2017

	War Ltd.	*Peace Ltd.*
	₹	₹
Balance as on 31.3.2015	80,000	(80,000)
Profit/(Loss)		
For 2015-2016	1,60,000	(40,000)
For 2016-2017	2,00,000	(60,000)
Less: Transfer to General Reserve		
2015-2016	(20,000)	
2016-2017	(20,000)	
Dividend @ 10%		
2015-2016	(1,05,000)	
2016-2017	(1,05,000)	
Investment written off		
2015-2016	(24,000)	
2016-2017	(24,000)	

Provision for share of loss in subsidiary		
2015-2016: (40,000 × 80%)	(32,000)	
2016-2017: (60,000× 80%)	(48,000)	
	62,000	(1,80,000)

Note: In the absence of information, taxation has not been considered.

3. Fixed Assets as on 31st March, 2017

	War Ltd.	*Peace Ltd.*
	₹	₹
Fixed assets on 31.3.2015	6,50,000	2,00,000
Less: Depreciation for		
2015-2016	(60,000)	(20,000)
2016-2017	(40,000)	(20,000)
	5,50,000	1,60,000

4. General reserve of War Ltd.

	₹
Balance as on 31.03.2015	1,20,000
Add: Transfer from Profit and loss account	
in 2015-2016	20,000
in 2016-2017	20,000
	1,60,000

5. Separate Balance Sheets as at 31st March, 2017 to calculate net current assets

Particulars	*Note No.*	*War Ltd.*	*Peace Ltd.*
		(₹)	*(₹)*
I. Equity and Liabilities			
(1) Shareholder's Funds			
(a) Share Capital	1	10,50,000	6,00,000
(b) Reserves and Surplus	2	3,42,000	(1,40,000)
(2) Non-Current Liabilities			
Long-term borrowings	3	6,00,000	
Long term provision	4	80,000	
Total		20,72,000	4,60,000

II. Assets			
(1) Non-current assets			
(a) Fixed assets			
(i) Tangible assets* (W.N.3)		5,50,000	1,60,000
(b) Non-current investment		6,72,000	
(2) Net current assets (bal. fig.) (see note)		8,50,000	3,00,000
Total		20,72,000	4,60,000

Notes to Accounts

			War Ltd.	Peace Ltd.
			₹	₹
1.	Share Capital			
	Issued and Subscribed:			
	1,05,000 shares of ₹ 10 each fully paid up		10,50,000	
	60,000 shares of ₹ 10 each fully paid up			6,00,000
2.	Reserves & surplus			
	Securities premium	1,20,000		-
	General Reserve (W.N. 4)	1,60,000		40,000
	Profit and Loss Account	62,000	3,42,000	(1,80,000)
	Total		3,42,000	(1,40,000)
3.	Long Term Borrowings			
	8% Debentures		6,00,000	
4.	Long term Provision			
	Provision for loss in subsidiary		80,000	

Note: In the absence of information about the movement in individual current assets and current liabilities, balance sheets as on 31.3.2017 have been prepared on the basis of net current assets, which is the difference of total current assets and total current liabilities. However, Schedule III requires separate disclosure of current liabilities and current assets in the balance sheet.

* Fixed assets given in the question are assumed to be tangible fixed assets.

(6) Computations for Consolidation

(a) Analysis of General reserve and Profits (Losses) of Peace Ltd.

	Pre-acquisition Capital Profit or loss ₹	*Post acquisition Profit or loss* ₹
General Reserve on 31.3.2015	40,000	–
Profit and Loss Account on 31.3.2015	(80,000)	
Profit/(Loss) for the years 2015 – 2016		(40,000)
2016 - 2017		(60,000)
	(40,000)	(1,00,000)
Minority Interest (20%)	(8,000)	(20,000)
Share of War Ltd. (80%)	(32,000)	(80,000)

(b) Minority Interest

	₹
Share Capital	1,20,000
Add: Pre-acquisition capital loss	(8,000)
Post-acquisition loss	(20,000)
	92,000

(c) Cost of Control

		₹
Investment in Peace Ltd.		6,72,000
Less: Paid up value of investment	4,80,000	
Capital profit/(losses)	(32,000)	(4,48,000)
Goodwill		2,24,000

(d) Consolidated Profit and Loss Account

	₹
Balance of Profit and Loss Account of War Ltd.	62,000
Less: Share of loss in Peace Ltd.	(80,000)
	(18,000)
Add back: Provision for loss in subsidiary (mutual transaction) (32,000 + 48,000)	80,000
	62,000

(e)	**Long term provision for loss in subsidiary as**	₹
	Provision for loss in subsidiary as shown in War Ltd.	80,000
	Less: Intra company transaction	(80,000)
		Nil

Question 6

The summarized balance sheets of two companies, Major Ltd. and Minor Ltd. as at 31st March, 2017 are given below:

Particulars	*Major Ltd.*	*Minor Ltd.*
	₹	₹
Assets:		
Plant and Machinery	*4,14,000*	*1,00,800*
Furniture	*14,000*	*9,200*
18,000, Ordinary shares in Minor Ltd.	*2,40,000*	-
4,000, Ordinary shares in Major Ltd.	-	*48,000*
Inventory in Trade	*96,000*	*2,28,000*
Trade receivables	*1,40,000*	*1,70,000*
Cash at Bank	*34,000*	*26,000*
	9,38,000	*5,82,000*
Liabilities:		
Ordinary shares of ₹ 10 each	*3,60,000*	*2,00,000*
7.5% Preference shares of ₹ 10 each	*3,00,000*	*1,60,000*
Reserves	*52,000*	*60,000*
Trade payables	*1,06,000*	*1,22,000*
Profit and Loss account	*1,20,000*	*40,000*
	9,38,000	*5,82,000*

Major Ltd. acquired the shares of Minor Ltd. on 1st October, 2016. As on 31st March, 2016, the plant and machinery stood in the books at ₹ 1,12,000, the reserve at ₹ 60,000 and the profit and loss account at ₹ 16,000. The plant and machinery was revalued by Major Ltd. on the date of acquisition of shares of Minor Ltd. at ₹ 1,20,000 but no adjustments were made in the books of Minor Ltd.

On 31st March, 2016, the debit balance of profit and loss account was ₹ 45,500 in the books of Major Ltd.

Both the companies have provided depreciation on all their fixed assets at 10% p.a.

You are required to prepare a Consolidated Balance Sheet as on 31st March, 2017 as per Schedule III.

Answer

Note: It is assumed that the preference shares given in the question are non-convertible in the nature.

Consolidated Balance Sheet of Major Ltd., and its subsidiary Minor Ltd. as on 31st March, 2017

Particulars	*Notes No.*	₹
I. Equity and Liabilities		
(1) Shareholders' Funds		
(a) Share Capital	1	6,20,000
(b) Reserves and Surplus	2	1,69,610
(2) Minority Interest	3	2,05,090
(3) Current Liabilities		
(a) Trade Payables (1,06,000 + 1,22,000)		2,28,000
(b) Other current liabilities (Preference dividend of Major Ltd.)		22,500
Total		12,45,200
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets	4	5,51,200
(2) Current assets		
(a) Inventories ₹ (96,000+2,28,000)		3,24,000
(b) Trade receivables ₹ (1,40,000+1,70,000)		3,10,000
(c) Cash & Cash equivalents ₹ (34,000+26,000)		60,000
Total		12,45,200

Notes to Accounts

			₹
1.	Share Capital		
	36,000 Equity shares of ₹ 10 each of Major Ltd.	3,60,000	
	Less : Shares held by Minor Ltd.	(40,000)	
		3,20,000	

	30,000, 7.5% Preference shares of ₹ 10 each fully paid of Major Ltd.			3,00,000	6,20,000
2.	Reserves and Surplus				
(a)	Reserves	52,000			
	Less: Share of Minor Ltd.	(17,042)		34,958	
(b)	Profit & Loss account	1,20,000			
	Less: Preference dividend	(22,500)			
		97,500			
	Less: Share of Minor Ltd.	(12,659)			
		84,841			
	Add: Share of revenue profit of Minor Ltd.	16,433		1,01,274	
(c)	Capital Reserve of Major Ltd.	41,378			
	Less: Goodwill of Minor Ltd.	(8,000)		33,378	1,69,610
3.	Minority Interest				
	Preference shares of Minor Ltd.			1,60,000	
	Preference dividend paid by Minor Ltd.			12,000	
	Equity shares (10%)			20,000	
	Capital profit (W.N. iv)			11,264	
	Revenue profit (W.N. v)			1,826	2,05,090
4.	Tangible Assets				
	Plant & Machinery				
	Major Ltd.		4,14,000		
	Minor Ltd. (1,00,800+13,600-400)		1,14,000	5,28,000	
	Furniture (14,000+9,200)			23,200	5,51,200

Working Notes:

(i) (a) Analysis of profits of Minor Ltd. (Pre-allocation of inter-company's share)

		Capital Profit ₹	*Revenue Profit* ₹
Reserves		60,000	
Profit and Loss as on 1.4.2016		16,000	
Profit for the year (40,000 – 16,000)	24,000		

Less: Preference dividend* (as per para 27 of AS 21)	(12,000)		
	12,000	6,000	6,000
Profit on upward revaluation (W.N. vii)		13,600	
Additional depreciation on upward revaluation (W.N. viii)		______	(400)
		95,600	5,600

(b) Analysis of Profits of Major Ltd.

		Capital Profit ₹	*Revenue Profit* ₹
Reserves during the year		26,000	26,000
Profit and Loss as on 1.4.2016		(45,500)	
Profit for the year (1,20,000 + 45,500)	1,65,500		
Less: Preference dividend	(22,500)		
	1,43,000	71,500	71,500
		52,000	97,500

(ii) Capital profits of Major Ltd. & Minor Ltd. (post allocation of inter-company's share)

Suppose capital profits of Major Ltd. = a

and capital profits of Minor Ltd. = b

Total Capital profits of Major Ltd. $= 52{,}000 + \frac{9}{10} b$ (1)

Total Capital profits of Minor Ltd. $= 95{,}600 + \frac{1}{9} a$ (2)

Putting values of equation (2) in (1), we get

$$a = 52{,}000 + \frac{9}{10}\left[95{,}600 + \frac{1}{9}a\right]$$

$$a = 52{,}000 + \frac{9}{10} \times \frac{8{,}60{,}400 + a}{9}$$

$$a = 52{,}000 + 86{,}040 + \frac{a}{10}$$

$$a - \frac{a}{10} = 1{,}38{,}040$$

* It is assumed that adjustment of preference dividend has not been done earlier.

$9a = 13,80,400$

$a = \frac{13,80,400}{9}$

$a = 1,53,378$

$b = 95,600 + \frac{1}{9}(1,53,378)$

$b = 1,12,642$

(iii) Revenue profits of Major Ltd. and Minor Ltd. (post allocation of inter-company's share)

Suppose revenue profits of Major Ltd. = x

and revenue profits of Minor Ltd.= y

Total Revenue profits of Major Ltd. = $97,500 + \frac{9}{10}y$ (3)

Total Revenue profits of Minor Ltd. = $5,600 + \frac{1}{9}x$ (4)

By solving the above equations (3) and (4) in line with the equations (1) and (2) of capital profit, we will get

x = 1,13,933 and y = 18,259

		Major Ltd. ₹	*Minor Ltd.* ₹
(iv)	**Capital Profits**		
	As per W.N.(ia) & (ib)	52,000	95,600
	Adjustment as per W.N.(ii) (1,53,378/9)	(17,042)	17,042
		34,958	1,12,642
	Minority Interest (10%)		(11,264)
	Share of Major Ltd.		1,01,378
(v)	**Revenue Profits**		
	As per W.N.(ia) & (ib)	97,500	5,600
	Adjustment as per W.N.(iii)	(12,659)	12,659
		84,841	18,259
	Minority interest of Minor Ltd.	-	(1,826)
	Share of Major Ltd. in Minor Ltd.	16,433	16,433
		1,01,274	

(vi)	**Cost of Control**		
	(a) Cost of investment of Major Ltd. in Minor Ltd.		2,40,000
	Less: Paid up value of shares (18,000 x ₹ 10)	1,80,000	
	Capital Profits	1,01,378	(2,81,378)
	Capital Reserve		41,378
	(b) Cost of investment of Minor Ltd. in Major Ltd.		48,000
	Less: Paid up value of shares held		(40,000)
	Goodwill		8,000
(vii)	**Plant and Machinery as on 1.1.2016**		1,12,000
	Less: Depreciation upto 30th September, 2016 (1,12,000 x 10% x 6/12)		(5,600)
	Value as on 1.10.2016		1,06,400
	Revaluation of Plant and Machinery on 1.10.2016		1,20,000
	Profit on upward revaluation		13,600
(viii)	**Additional depreciation on upward Revaluation of Plant and Machinery**		
	Depreciation for remaining 6 months (1,20,000 x 10% x 6/12)		6,000
	Less: Depreciation already charged (1,12,000 x 10% x 6/12)		(5,600)
			400

Problems Involving One Subsidiary – Different Dates of Acquisition

Question 7

The summarized Balance Sheets of Football Ltd. and its subsidiary Hockey Ltd. as on 31st March, 2017 are as under:

Liabilities	*Football Ltd.* ₹	*Hockey Ltd.* ₹	*Assets*	*Football Ltd.* ₹	*Hockey Ltd.* ₹
Equity shares of ₹ 10 each	*48,00,000*	*20,00,000*	*Goodwill*	*4,50,000*	*3,00,000*
10% Preference shares of ₹ 10 each	*7,00,000*	*3,80,000*	*Plant and machinery*	*12,00,000*	*5,00,000*
			Motor vehicles	*9,50,000*	*7,50,000*
General reserve	*5,50,000*	*4,20,000*	*Furniture and fittings*	*6,50,000*	*4,00,000*
Profit and loss account	*10,00,000*	*6,00,000*			

Bank overdraft	*1,20,000*	*70,000*	*Investments*	*26,00,000*	*4,50,000*
Trade payables	*4,30,000*	*6,40,000*	*Inventory*	*4,50,000*	*7,20,000*
			Cash at bank	*2,25,000*	*2,10,000*
			Trade receivables	*10,75,000*	*7,80,000*
	76,00,000	*41,10,000*		*76,00,000*	*41,10,000*

Details of acquisition of shares by Football Ltd. are as under:

Nature of shares	*No. of shares acquired*	*Date of acquisition*	*Cost of acquisition ₹*
Preference shares	*14,250*	*1.4.2014*	*3,10,000*
Equity shares	*80,000*	*1.4.2015*	*9,50,000*
Equity shares	*70,000*	*1.4.2016*	*8,00,000*

Other information:

(i) On 1.4.2016 profit and loss account and general reserve of Hockey Ltd. had credit balances of ₹ 3,00,000 and ₹ 2,00,000 respectively.

(ii) Dividend @ 10% was paid by Hockey Ltd. for the year 2015-2016 out of its profit and loss account balance as on 1.4.2016. Football Ltd. credited its share of dividend to its profit and loss account.

(iii) Hockey Ltd. allotted bonus shares out of general reserve at the rate of 1 share for every 10 shares held. Accounting thereof has not yet been made.

(iv) During the year 2016-2017 Football Ltd. purchased goods from Hockey Ltd. for ₹ 1,00,000 at a sale price of ₹ 1,20,000. 40% of these goods remained unsold at close of the year.

(v) On 1.4.2016 motor vehicles of Hockey Ltd. were overvalued by ₹ 1,00,000. Applicable depreciation rate is 20%.

(vi) Dividends recommended for the year 2016-2017 in the holding and the subsidiary companies are 15% and 10% respectively.

(vii) Details of Trade payables and Trade receivables:

	Football Ltd.	*Hockey Ltd.*
Trade payables		
Bills Payable	*–*	*1,60,000*
Sundry creditors	*4,30,000*	*4,80,000*
	4,30,000	*6,40,000*

Trade receivables		
Debtors	*9,30,000*	*7,80,000*
Bills Receivables	*1,45,000*	*–*
	10,75,000	*7,80,000*

(vi) Bills receivable of Football Ltd. were drawn upon Hockey Ltd.

Prepare consolidated Balance Sheet as on 31st March, 2017.

Answer

Note: It is assumed that the preference shares given in the question are non-convertible in the nature.

Consolidated Balance Sheet of Football Ltd. and its subsidiary Hockey Ltd. as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) Shareholder's Funds		
(a) Share Capital	1	55,00,000
(b) Reserves and Surplus	2	12,24,750
(2) **Minority Interest (W.N.3)**		9,11,000
(3) **Current Liabilities**		
(a) Short term borrowings	3	1,90,000
(b) Trade payables	4	9,25,000
(c) Other current liabilities	5	8,63,750
Total		96,14,500
II. **Assets**		
(1) **Non-current assets**		
(a) Fixed assets		
i. Tangible assets	6	43,70,000
ii. Intangible assets	7	9,47,500
(b) Non-current investments	8	9,90,000
(2) **Current assets**		
(a) Inventories	9	11,62,000
(b) Trade receivables	10	17,10,000
(c) Cash and cash equivalents	11	4,35,000
Total		96,14,500

Notes to Accounts

			₹	₹
1.	Share Capital			
	Authorised, Issued and paid up capital			–
	4,80,000, Equity shares of ₹ 10 each		48,00,000	
	70,000, 10% preference shares of ₹ 10 each		7,00,000	55,00,000
2.	Reserves and surplus			
	General reserve – Football Ltd.			
	Balance	5,50,000		
	Add: Share in Hockey Ltd. [W.N. 1]	1,65,000	7,15,000	
	Profit and loss account (W.N. 4)		5,09,750	12,24,750
3.	Short term borrowings			
	Bank Overdraft			
	Football Ltd.		1,20,000	
	Hockey Ltd.		70,000	1,90,000
4.	Trade payables			
	Football Ltd.		4,30,000	
	Hockey Ltd.		6,40,000	
	Less: Mutual debt		(1,45,000)	9,25,000
5.	Other current liabilities			
	Dividend payable			
	Football Ltd.			
	Equity		7,20,000	
	Preference		70,000	7,90,000
	Hockey Ltd.			
	Equity		50,000	
	Preference		23,750	73,750
				8,63,750
6.	Tangible assets			
	Plant and Machinery			
	Football Ltd.	₹ 12,00,000		
	Hockey Ltd.	₹ 5,00,000	17,00,000	

	Motor Vehicles			
	Football Ltd.	₹ 9,50,000		
	Hockey Ltd. (₹ 7,50,000–1,00,000+ 20,000)	6,70,000	16,20,000	
	Furniture & Fittings			
	Football Ltd.	₹ 6,50,000		
	Hockey Ltd.	₹ 4,00,000	10,50,000	43,70,000
7.	Intangible assets			
	Goodwill			
	Football Ltd.		4,50,000	
	Hockey Ltd.		3,00,000	
			7,50,000	
	Add: Goodwill on consolidation (W.N. 2)		1,97,500	9,47,500
8.	Non-current investments			
	Investments			
	Football Ltd. (₹ 26,00,000 – 20,60,000)		5,40,000	
	Hockey Ltd.		4,50,000	9,90,000
9.	Inventories			
	Inventory			
	Football Ltd.		4,50,000	
	Hockey Ltd.		7,20,000	
			11,70,000	
	Less: Unrealised profit		(8,000)	11,62,000
10.	Trade receivables			
	Football Ltd.		10,75,000	
	Hockey Ltd.		7,80,000	
	Less: Mutual Debt		(1,45,000)	17,10,000
11.	Cash and cash equivalents			
	Cash at Bank			
	Football Ltd.		2,25,000	
	Hockey Ltd.		2,10,000	4,35,000

Working Notes:

(1)	**Analysis of Profits of Hockey Ltd.**	₹	*Capital Profits* ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
(a)	General Reserve as on 1.4.2016	2,00,000			
	Less: Bonus issue (1/10 of ₹ 20,00,000)	(2,00,000)	–	–	
(b)	Addition to General Reserve during 2016-2017 (₹ 4,20,000 – ₹ 2,00,000)			2,20,000	
(c)	Profit and Loss Account balance as on 1.4.2016	3,00,000			
	Less: Dividend paid for the year 2015-2016	(2,00,000)	1,00,000		
(d)	Profit for the year 2016-2017 (₹ 6,00,000 – ₹ 1,00,000)				5,00,000
(e)	Adjustment for over valuation of motor vehicles		(1,00,000)		
(f)	Adjustment of revenue profit due to overcharged depreciation (20% on ₹ 1,00,000)				20,000
(g)	Preference dividend for the year 2016-2017 @ 10%				(38,000)
			–	2,20,000	4,82,000
	Football Ltd.'s share (3/4)			1,65,000	3,61,500
	Minority Interest (1/4)			55,000	1,20,500
				2,20,000	4,82,000

(2)	**Cost of Control**	₹	₹
	Cost of investments in Hockey Ltd.		20,60,000
	Less: Paid up value of equity shares (including bonus shares) [80,000 + 70,000 + (10% of 1,50,000)] × ₹ 10	16,50,000	

	Paid-up value of preference shares	1,42,500	
	Pre-acquisition dividend*	70,000	(18,62,500)
	Cost of control/Goodwill		1,97,500
(3)	**Minority Interest**		
	Equity share capital [₹ 5,00,000 + ₹ 50,000 (Bonus)]		5,50,000
	Preference share capital (₹ 3,80,000 – ₹ 1,42,500)		2,37,500
	Share of revenue reserve [W.N. 1]		55,000
	Share of revenue profit [W.N. 1]		1,20,500
	Preference dividend		23,750
	Less: Unrealised gain 8,000 x 1/4		(2,000)
			9,84,750
	Less: Dividend payable		
	Equity	50,000	
	Preference	23,750	73,750
			9,11,000
(4)	**Profit and Loss Account – Football Ltd.**		
	Balance		10,00,000
	Share in profit of Hockey Ltd. [W.N. 1]		3,61,500
	Share in preference dividend of Hockey Ltd.		14,250
			13,75,750
	Less: Pre-acquisition dividend credited to profit and loss account*	70,000	
	Unrealised profit on inventory [(40% of ₹ 20,000)x ¾]	6,000	
	Equity dividend [48,00,000 x 15 %]	7,20,000	
	Preference dividend [7,00,000 x 10 %]	70,000	(8,66,000)
			5,09,750

Note: No information has been given in the question regarding date of bonus issue by Hockey. It is also not mentioned whether the bonus shares are issued from pre-acquisition general reserve or post-acquisition general reserve. The above solution is given on the basis that Hockey Ltd. allotted bonus shares out of pre-acquisition general reserve.

* The dividend on 70,000 shares only (acquired on 1.4.2016) is a pre-acquisition dividend.

Question 8

'HIM' Limited is a company carrying on the business of beauty products and is having a subsidiary 'SIM' Limited. Their Balance-sheets as on 31st March 2016 were as under:

	HIM Limited (₹)	SIM Limited (₹)
Equity and Liabilities		
Shareholders' Funds		
Share Capital	25,00,000	5,80,000
Reserves and Surplus		
General Reserve	2,00,000	1,20,000
Profit and Loss Account	3,12,500	2,05,000
Current Liabilities		
Trade Payables	4,55,000	2,35,500
Bills Payables	28,000	83,000
Total	34,95,500	12,23,500
Assets		
Non-current Assets		
Fixed Assets	21,70,000	6,25,000
Investments		
4060 Shares in SIM Limited	5,10,000	-
Current Assets		
Inventories	4,80,000	3,19,200
Trade Payable	1,80,000	1,64,000
Bills Receivable	68,000	1,00,000
Cash and Bank Balance	87,500	15,300
Total	34,95,500	12,23,500

HIM Limited has also given the following information:

(i) HIM Limited has acquired the shares in SIM Limited in two lots on two different dates. The relevant information at the time of acquisition of shares was as under:

No. of shares acquired	Balance in General Reserve	Balance in Profit and Loss Account
1st acquisition 3480	80,000	25,000
2nd acquisition 580	85,000	1,02,000

(ii) Bills Receivables of HIM Limited includes ₹15,000 being acceptance from SIM Limited.

(iii) Both the companies have declared dividend of 10% for the year ended on 31st March 2016, but it has not been provided in the books of accounts.

(iv) SIM Limited's inventory includes stock of ₹ 1,45,000 purchased from HIM Limited. HIM Limited sells goods at mark up of 25% on its cost.

Prepare the Consolidated Balance Sheet of HIM Limited along with 'Notes to accounts'.

Answer

Consolidated Balance Sheet of Him Ltd. and its subsidiary Sim Ltd.
as on 31st March, 2016

Particulars	*Note No.*	*₹*
I. Equity and Liabilities		
(1) Shareholder's Funds		
Share Capital	1	25,00,000
Reserves and Surplus	2	3,79,300
(2) Minority Interest (W.N.2)		2,54,100
(3) Current Liabilities		
Trade payables	3	7,86,500
Other Current liabilities	4	2,67,400
Total		41,87,300
II. Assets		
(1) Fixed Assets		
Tangible assets	5	27,95,000
Intangible assets	6	22,300
(2) Current assets		
Inventories	7	7,70,200
Trade Receivables	8	4,97,000
Cash and Cash equivalents	9	1,02,800
Total		41,87,300

Notes to Accounts

				₹
1.	**Share Capital**			
	Authorised, Issued, Subscribed and Paid up			
	25,000 Equity shares of ₹ 100 each			25,00,000
2.	**Reserves and Surplus**			
	General Reserve (W.N.4)		2,27,500	
	Profit & Loss Account (W.N.4)		1,51,800	3,79,300
3.	**Trade payables**			
	Trade Payables			
	Him Ltd.		4,55,000	
	Sim Ltd.		2,35,500	6,90,500
	Bills payable			
	Him Ltd.		28,000	
	Sim Ltd.	83,000		
	Less: Mutual owings	(15,000)	68,000	96,000
				7,86,500
4.	**Other Current liabilities**			
	Dividend payable			
	Him Ltd.		2,50,000	
	Minority Interest		17,400	2,67,400
5.	**Tangible assets**			
	Him Ltd.		21,70,000	
	Sim Ltd.		6,25,000	27,95,000
6.	**Intangible assets**			
	Goodwill (W.N.3)			22,300
7.	**Inventories**			
	Him Ltd.		4,80,000	
	Sim Ltd.		3,19,200	
			7,99,200	
	Less: Unrealised profit		(29,000)	7,70,200
8.	**Trade Receivables**			
	Trade Receivables			
	Him Ltd.		1,80,000	
	Sim Ltd.		1,64,000	3,44,000

	Bills Receivable			
	Him Ltd.	68,000		
	Less: Mutual owings	(15,000)	53,000	
	Sim Ltd.		1,00,000	1,53,000
				4,97,000
9.	**Cash and Cash equivalents**			
	Him Ltd.		87,500	
	Sim Ltd.		15,300	1,02,800

Working Notes:

1. **Analysis of Profits**

	Pre-acquisition Profits	*Post-acquisition*	
		General Reserve	*Profit & Loss Account*
	₹	₹	₹
General Reserve	80,000	40,000	
Profit & Loss Account	25,000	____	1,80,000
For Lot 1 (A)	1,05,000	40,000	1,80,000
Pre-acquisition for Lot 2			
General Reserve (85,000 – 80,000)		5,000	
Profit & Loss Account (1,02,000-25,000)			77,000
Post-acquisition for Lot 2		35,000	1,03,000
Him Ltd. (70%) of (A)	73,500	28,000	1,26,000
Adjustment of pre-acquisition General Reserve for Lot 2 (10%)	500	(500)	
Adjustment of pre-acquisition Profit & Loss Account for Lot 2 (10%)	7,700	____	(7,700)
Him Ltd.	81,700	27,500	1,18,300
Minority Interest (30%) of (A)	31,500	12,000	54,000

2. **Minority Interest**

	₹
Share Capital (30%)	1,74,000
Add: Share of pre-acquisition profit of Sim Ltd.	31,500

Share of post-acquisition General Reserve	12,000
Share of post-acquisition Profit & Loss Account	54,000
	2,71,500
Less: Share of Dividend payable	(17,400)
	2,54,100

3. Cost of Control/Goodwill

	₹
Cost of investments	5,10,000
Less: Share capital (70%)	(4,06,000)
Share of pre-acquisition profit	(81,700)
Goodwill	22,300

4. Consolidated General Reserve & Profit and Loss Account

	General Reserve	*Profit and Loss*
	₹	₹
Him Ltd.	2,00,000	3,12,500
Less: Dividend declared by Him Ltd.		(2,50,000)
Less: Unrealised profit		(29,000)
	2,00,000	33,500
Add: Share in post-acquisition item of Sim Ltd.	27,500	1,18,300
	2,27,500	1,51,800

Problems involving more than one subsidiary

Question 9

From the following summarized Balance Sheets of a group of companies and the other information provided, draw up the consolidated Balance Sheet as on 31.3.2017. Figures given are in ₹ Lakhs:

Balance Sheets as on 31.3.2017

	X	*Y*	*Z*		*X*	*Y*	*Z*
Shares capital (in shares of ₹ 100 each)	*300*	*200*	*100*	*Fixed Assets less depreciation*	*130*	*150*	*100*
Reserves	*50*	*40*	*30*	*Cost of investment in Y Ltd.*	*180*	–	–
Profit and loss balance	*60*	*50*	*40*	*Cost of investment in Z Ltd.*	*40*	–	–
Trade payables	*40*	*10*	*15*	*Cost of investment in Z Ltd.*	–	*80*	–
Y Ltd. balance	–	–	*15*	*Inventory*	*50*	*20*	*20*

Z Ltd. balance	50	–	–	Trade receivables	70	20	40
				Z Ltd. balance	–	10	–
				X Ltd. balance	–	–	30
				Cash and bank balance	30	20	10
	500	300	200		500	300	200

X Ltd. holds 1,60,000 shares and 30,000 shares respectively in Y Ltd. and Z Ltd.; Y Ltd. holds 60,000 shares in Z Ltd. These investments were made on 1.7.2016 on which date the provision was as follows:

	Y Ltd.	Z Ltd.
Reserves	20	10
Profit and loss account	30	16

In December, 2016 Y Ltd. invoiced goods to X Ltd. for ₹ 40 lakhs at cost plus 25%. The closing inventory of X Ltd. includes such goods valued at ₹ 5 lakhs.

Z Ltd. sold to Y Ltd. an equipment costing ₹ 24 lakhs at a profit of 25% on selling price on 1.1.2017. Depreciation at 10% per annum was provided by Y Ltd. on this equipment.

X Ltd. proposes dividend at 10%.

Details of Trade payables and Trade receivables:

	X	Y	Z
Trade payables			
Bills Payable	10	-	5
Sundry creditors	30	10	10
	40	10	15
Trade receivables			
Debtors	70	10	20
Bills Receivables	-	10	20
	70	20	40

Bills payables of Z Ltd. represent acceptances given to Y Ltd. out of which Y Ltd. had discounted bills worth ₹ 3 lakhs.

Trade receivables of X Ltd. include ₹ 5 lakhs being the amount due from Y Ltd.

Answer

**Consolidated Balance Sheet of X Ltd.
and its subsidiaries Y Ltd. and Z Ltd.
as at 31st March, 2017**

Particulars	*Note No.*	*(₹ in Lacs)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		300.00
(b) Reserves and Surplus	1	151.90
(2) **Minority Interest (W.N 4)**		79.30
(3) **Current Liabilities**		
(a) Trade payables	2	58.00
(b) Other current liabilities	3	55.00
Total		644.20
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
Tangible assets	4	372.20
(2) **Current assets**		
(a) Inventories	5	89.00
(b) Trade receivables	6	123.00
(c) Cash and cash equivalents	7	60.00
Total		644.20

Notes to Accounts

			(₹ in lacs)	*(₹ in lacs)*
1.	Reserves and Surplus			
	Capital Reserve [W.N. 3]		13.40	
	Other Reserves [W.N. 7]		81.60	
	Profit and Loss Account [W.N. 6]		56.90	151.90
2.	Trade payables			
	X Ltd.	₹ 40.00		
	Y Ltd.	₹ 10.00		

	Z Ltd.	₹ 15.00	65.00	
	Less: Mutual indebtedness	₹ (5.00)		
	Less :Mutual indebtedness [5-3]	₹ (2.00)	(7.00)	58.00
3.	Other current liabilities			
	(a) Current Account Balances			
	X Ltd.	₹ 50.00		
	Z Ltd.	₹ 15.00		
		₹ 65.00		
	Less: Mutual indebtedness (₹ 10+ 30)	(₹ 40.00)	25.00	
	(b) Dividend payable		30.00	55.00
4.	Tangible assets			
	Fixed Assets			
	X Ltd.		130.00	
	Y Ltd.		150.00	
	Z Ltd.		100.00	
			380.00	
	Less: Unrealised profit [W.N. 5]		(7.80)	372.20
5.	Inventories			
	X Ltd.		50.00	
	Y Ltd.		20.00	
	Z Ltd.		20.00	
			90.00	
	Less: Unrealised profit [5 x 25 / 125]		(1.00)	89.00
6.	Trade receivables			
	X Ltd.	₹ 70.00		
	Y Ltd.	₹ 20.00		
	Z Ltd.	₹ 40.00	130.00	
	Less: Mutual indebtedness	₹ (5.00)		
	Less: Mutual indebtedness	₹ (2.00)	(7.00)	123.00
7.	Cash and Cash Equivalents			
	X Ltd.	₹ 30.00		
	Y Ltd.	₹ 20.00		
	Z Ltd.	₹ 10.00		60.00

Working Notes:

Shareholding Pattern

	Y Ltd.	Z Ltd.
Total Shares	2 lakh shares	1 lakh shares
X Ltd's holding	1.6 lakh shares [80 %]	.3 lakhs [30%]
Y Ltd's holding	NA	.6 lakhs [60%]
Minority Holding	.4 lakh shares (20 %)	.1 lakh shares (10%)

		(₹ in lakhs)		
		Capital Profit	*Revenue Reserve*	*Revenue profit*
(1)	Analysis of Profits of Z Ltd.			
	Reserves on 1.7.2016	10.00		
	Profit and Loss A/c on 1.7.2016	16.00		
	Increase in Reserves		20.00	
	Increase in Profit			24.00
		26.00	20.00	24.00
	Less: Minority Interest (10%)	(2.60)	(2.00)	(2.40)
		23.40	18.00	21.60
	Share of X Ltd. [30%]	7.80	6.00	7.20
	Share of Y Ltd. [60%]	15.60	12.00	14.40
(2)	Analysis of Profits of Y Ltd.			
	Reserves on 1.7.2016	20.00		
	Profit and Loss A/c on 1.7.2016	30.00		
	Increase in Reserves		20.00	
	Increase in Profit			20.00
		50.00	20.00	20.00
	Share in Z Ltd. [WN 1]		12.00	14.40
		50.00	32.00	34.40
	Less: Minority Interest (20%)	(10.00)	(6.40)	(6.88)
	Share of X Ltd.[80%]	40.00	25.60	27.52
(3)	Cost of Control			
	Investments in Y Ltd.			180.00
	Investments in Z Ltd.			120.00
				300.00

	Less: Paid up value of investments			
	in Y Ltd.	(160.00)		
	in Z Ltd.	(90.00)	(250.00)	
	Capital Profit			
	in Y Ltd. [WN 1]	(40.00)		
	in Z Ltd. [WN 2]	(23.40)	(63.40)	(313.40)
	Capital Reserve			13.40
(4)	Minority Interest	Y Ltd.	Z Ltd.	
	Share Capital	40.00	10.00	
	Capital Profit	10.00	2.60	
	Revenue Reserves	6.40	2.00	
	Revenue Profits	6.88	2.40	
		63.28	17.00	
	Less: Unrealised profit on inventory (20% of 1)	(.20)		
	Unrealised profit on equipment (10% of ₹7.8)		(0.78)	
		63.08	16.22	
(5)	Unrealised Profit on equipment sale			
	Cost	24.00		
	Profit [25 % on selling price]	8.00		
	Selling Price	32.00		
	Unrealised profit = $\left[8-\left(8\times\frac{10}{100}\times\frac{3}{12}\right)\right]$			
	= 8.00 – 0.20 = 7.80			
(6)	Profit and Loss Account – X Ltd.			
	Balance	60.00		
	Less: Dividend	(30.00)		
		30.00		
	Share in Y Ltd.	27.52		
	Share in Z Ltd.	7.20		
		64.72		
	Less: Unrealised profit on equipment (90% of 7.8)	(7.02)		
		57.70		

	Less: Unrealised profit on inventory $\left(5 \times \frac{25}{125} \times 80\%\right)$	(0.80)		
		56.90		
(7)	Reserves – X Ltd.			
	X Ltd.	50.00		
	Share in Y Ltd. [WN 2]	25.60		
	Share in Z Ltd. [WN 1]	6.00		
		81.60		

Question 10

Following are the summarized Balance Sheets of Mumbai Limited, Delhi Limited, Amritsar Limited and Kanpur Limited as at 31st March, 2017:

Liabilities	*Mumbai Ltd.*	*Delhi Ltd.*	*Amritsar Ltd.*	*Kanpur Ltd.*
Share Capital (₹ 100 face value)	*50,00,000*	*40,00,000*	*20,00,000*	*60,00,000*
General Reserve	*20,00,000*	*4,00,000*	*2,50,000*	*10,00,000*
Profit & Loss Account	*10,00,000*	*4,00,000*	*2,50,000*	*3,20,000*
Trade payables	*3,00,000*	*1,00,000*	*50,000*	*80,000*
	83,00,000	*49,00,000*	*25,50,000*	*74,00,000*
Assets				
Investments:				
30,000 shares in Delhi Ltd.	*35,00,000*	—	—	—
10,000 shares in Amritsar Ltd	*11,00,000*	—	—	—
5,000 shares in Amritsar Ltd.	—	*5,00,000*	—	—
Shares in Kanpur Ltd. @ ₹ 120	*36,00,000*	*18,00,000*	*6,00,000*	—
Fixed Assets	—	*20,00,000*	*15,00,000*	*70,00,000*
Current Assets	*1,00,000*	*6,00,000*	*4,50,000*	*4,00,000*
	83,00,000	*49,00,000*	*25,50,000*	*74,00,000*

Balance in General Reserve Account and Profit & Loss Account, when shares were purchased in different companies were:

	Mumbai Ltd.	*Delhi Ltd.*	*Amritsar Ltd.*	*Kanpur Ltd.*
General Reserve Account	*10,00,000*	*2,00,000*	*1,00,000*	*6,00,000*
Profit & Loss Account	*6,00,000*	*2,00,000*	*50,000*	*60,000*

Prepare the consolidated Balance Sheet of the group as at 31st March, 2017 (Calculations may be rounded off to the nearest rupee).

Answer

Consolidated Balance Sheet of Mumbai Ltd. and its subsidiaries Delhi Ltd., Amritsar Ltd. and Kanpur Ltd. As at 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	50,00,000.00
(b) Reserves and Surplus	2	40,32,187.50
(2) **Minority Interest (W.N.5)**		31,25,312.50
(3) **Current Liabilities**		
Trade payables		5,30,000.00
Total		1,26,87,500.00
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
i. Tangible assets		105,00,000.00
ii. Intangible assets [WN 4]		6,37,500.00
(2) **Current assets**		15,50,000.00
Total		1,26,87,500.00

Notes to Accounts

		(₹)	*(₹)*
1.	Share Capital		
	(Fully paid shares of ₹100 each)		50,00,000.00
2.	Reserves and surplus		
	General Reserve (W.N.6)	25,51,041.67	
	Profit and Loss Account (W.N.7)	14,81,145.83	40,32,187.50

Working Notes:

Shareholding Pattern

	Delhi	*Amritsar*	*Kanpur*
Total Shares	40,000	20,000	60,000
Held by Mumbai	30,000 [75%]	10,000 [50%]	30,000 [50%]

Held by Delhi	NA	5,000 [25%]	15,000 [25%]
Held by Amritsar	NA	NA	5,000 [8.33%]
Minority Interest	25 %	25 %	16.67%

1 Analysis of profits of Kanpur Ltd.

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
General Reserve on the date of purchase of shares	6,00,000.00		
Profit and Loss A/c on the date of purchase of shares	60,000.00		
Increase in General Reserve		4,00,000.00	
Increase in profit	-	-	2,60,000.00
	6,60,000.00	4,00,000.00	2,60,000.00
Less: Minority Interest (1/6)	(1,10,000.00)	(66,666.67)	(43,333.33)
	5,50,000.00	3,33,333.33	2,16,666.67
Share of Mumbai Ltd. (1/2)	3,30,000.00	2,00,000.00	1,30,000.00
Share of Delhi Ltd. (1/4)	1,65,000.00	1,00,000.00	65,000.00
Share of Amritsar Ltd. (1/12)	55,000.00	33,333.33	21,666.67

2 Analysis of profits of Amritsar Ltd.

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
General Reserve on the date of purchase of shares	1,00,000.00		
Profit and Loss A/c on the date of purchase of shares	50,000.00		
Increase in General Reserve		1,50,000.00	
Increase in Profit and Loss A/c			2,00,000.00
Share in Kanpur Ltd. [WN 1]	-	33,333.33	21,666.67
	1,50,000.00	1,83,333.33	2,21,666.67
Less: Minority Interest (1/4)	(37,500.00)	(45,833.33)	(55,416.67)
	1,12,500.00	1,37,500.00	1,66,250.00
Share of Mumbai Ltd. (1/2)	75,000	91,666.67	1,10,833.33
Share of Delhi Ltd. (1/4)	37,500	45,833.33	55,416.67

3. Analysis of profits of Delhi Ltd.

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
General Reserve on the date of purchase of shares	2,00,000.00		
Profit and Loss A/c on the date of purchase of shares	2,00,000.00		
Increase in General Reserve		2,00,000.00	
Increase in Profit and Loss A/c			2,00,000.00
Share in Kanpur Ltd. [WN 1]		1,00,000.00	65,000.00
Share in Amritsar Ltd. [WN 2]	-	45,833.33	55,416.67
	4,00,000.00	3,45,833.33	3,20,416.67
Less: Minority Interest (1/4)	(1,00,000.00)	(86,458.33)	(80,104.17)
Share of Mumbai Ltd. (3/4)	3,00,000.00	2,59,375.00	2,40,312.50

4. Cost of control

Investments in		₹
Delhi Ltd.	35,00,000	
Amritsar Ltd. [11 + 5]	16,00,000	
Kanpur Ltd.	60,00,000	
		1,11,00,000
Paid up value of investments in		
Delhi Ltd.	30,00,000	
Amritsar Ltd.	15,00,000	
Kanpur Ltd. [36+18+6]/120x1,00,000	50,00,000	(95,00,000)
Capital profits in		
Delhi Ltd. [W.N.3]	3,00,000	
Amritsar Ltd. [W.N.2]	1,12,500	
Kanpur Ltd. [W.N.1]	5,50,000	(9,62,500)
Goodwill		6,37,500

5. Minority interest

Share Capital:		
Delhi Ltd. (1/4)	10,00,000.00	
Amritsar Ltd. (1/4)	5,00,000.00	
Kanpur Ltd (1/6)	10,00,000.00	25,00,000.00
Share in profits & reserves		
(Pre and Post-Acquisitions)		
Delhi Ltd. [W.N.3]	2,66,562.50	
Amritsar Ltd. [W.N.2]	1,38,750.00	
Kanpur Ltd.	2,20,000.00	6,25,312.50
		31,25,312.50

6. General Reserve — Mumbai Ltd.

Balance as on 31.3.2017 (given)	20,00,000.00
Share in	
Delhi Ltd. [W.N.3]	2,59,375.00
Amritsar Ltd. [W.N.2]	91,666.67
Kanpur Ltd. [W.N.1]	2,00,000.00
	25,51,041.67

7. Profit and Loss Account — Mumbai Ltd.

Balance as on 31.3.2017 (given)	10,00,000.00
Share in	
Delhi Ltd. [W.N.3]	2,40,312.50
Amritsar Ltd. [W.N.2]	1,10,833.33
Kanpur Ltd. [W.N.1]	1,30,000.00
	14,81,145.83

Question 11

A Limited is a holding company and B Limited and C Limited are subsidiaries of A Limited. Their summarized Balance Sheets as on 31.3.2017 are given below:

	A Ltd. ₹	B Ltd. ₹	C Ltd. ₹		A Ltd. ₹	B Ltd. ₹	C Ltd. ₹
Share Capital	1,00,000	1,00,000	60,000	Fixed Assets	20,000	60,000	43,000
Reserves	48,000	10,000	9,000	Investments			
Profit & Loss Account				Shares in B Ltd.	95,000		

	16,000	12,000	9,000	Shares in C Ltd.	13,000	53,000	
Trade payables	7,000	5,000		Inventory in Trade	12,000		
A Ltd. Balance		7,000		B Ltd. Balance	8,000		
C Ltd. Balance	3,000			Trade receivables	26,000	21,000	32,000
				A Ltd. Balance			3,000
	1,74,000	1,34,000	78,000		1,74,000	1,34,000	78,000

The following particulars are given:

(i) The Share Capital of all companies is divided into shares of ₹ 10 each.

(ii) A Ltd. held 8,000 shares of B Ltd. and 1,000 shares of C Ltd.

(iii) B Ltd. held 4,000 shares of C Ltd.

(iv) All these investments were made on 30.9.2016.

(v) On 31.3.2016, the position was as shown below:

	B Ltd. ₹	C Ltd. ₹
Reserve	8,000	7,500
Profit & Loss Account	4,000	3,000
Trade payables	5,000	1,000
Fixed Assets	60,000	43,000
Inventory in Trade	4,000	35,500
Trade receivables	48,000	33,000

(vi) 10% dividend is declared by each company.

(vii) The whole of inventory in trade of B Ltd. as on 30.9.2016 (₹ 4,000) was later sold to A Ltd. for ₹ 4,400 and remained unsold by A Ltd. as on 31.3.2017.

(viii) Cash-in-transit from B Ltd. to A Ltd. was ₹ 1,000 as at the close of business.

You are required to prepare the Consolidated Balance Sheet of the group as on 31.3.2017.

Answer

Consolidated Balance Sheet of A Ltd.
and its subsidiaries B Ltd. and C Ltd.
as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		1,00,000
(b) Reserves and Surplus	1	60,305
(2) **Minority Interest (W.N 5)**		34,820
(3) **Current Liabilities**		
(a) Trade payables		12,000
(b) Short term provisions	2	13,000
Total		2,20,125
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
i. Tangible assets		1,23,000
ii. Intangible assets	3	5,525
(2) **Current assets**		
(a) Inventories	4	11,600
(b) Trade receivables		79,000
(c) Cash and cash equivalents	5	1,000
Total		2,20,125

Notes to Accounts

		(₹)	*(₹)*
1.	Reserves and surplus		
	Reserves - Balance as on 31.3.2017 (given)	48,000	
	Share in		
	B Ltd. [WN 3]	1,200	
	C Ltd. [WN 2]	125	49,325
	Profit & Loss Account		
	Balance as on 31.3.2017 (given)	16,000	

	Share in		
	B Ltd. [WN 3]	4,800	
	C Ltd. [WN 2]	500	
		21,300	
	Less: Dividend (10% of ₹ 1,00,000)	(10,000)	
	Provision for unrealised profit on inventory [80% of (₹ 4,400 – ₹ 4,000)]	(320)	10,980
			60,305
2.	Other current liability		
	Dividend payable		
	A Ltd.	10,000	
	B Ltd.	2,000	
	C Ltd.	1,000	13,000
3.	Intangible Assets		
	Goodwill (W.N 4)		5,525
4.	Inventories		
	Inventory in Trade	12,000	
	Less: Provision for unrealised profit	(400)	11,600
5.	Cash and cash equivalents		
	Cash in Transit (₹8,000 – 7,000)		1,000

Working Notes:

Shareholding Pattern

	B Ltd.	C Ltd.
Total Shares	10,000	6,000
Held by A Ltd.	8,000 [80%]	1,000 [1/6th]
Held by B Ltd.	NA	4,000 [4/6th]
Minority Holding	20 %	1/6th

(1) Position on 30.09.2016 i.e. date of investment

	Reserves	*Profit and Loss Account*
B Ltd.	₹	₹
Balance on 31.3.2017	10,000	12,000
Less: Balance on 31.3.2016	(8,000)	(4,000)
Increase during the year	2,000	8,000
Estimated increase for half year	1,000	4,000

Balance on 30.9.2016	9,000 (8,000 + 1,000)	8,000 (4,000 + 4,000)
C Ltd.		
Balance on 31.3.2017	9,000	9,000
Balance on 31.3.2016	7,500	3,000
Increase during the year	1,500	6,000
Estimated increase for half year	750	3,000
Balance on 30.9.2016	8,250 (7,500 + 750)	6,000 (3,000 + 3,000)

(2) Analysis of Profits of C Ltd.

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue profit* ₹
Reserves on 30.9.2016 [WN 1]	8,250		
Profit and Loss A/c on 30.9.2016	6,000		
Increase in reserves		750	
Increase in profit			3,000
	14,250	750	3,000
Less: Minority interest (1/6)	(2,375)	(125)	(500)
	11,875	625	2,500
Share of A Ltd. (1/6)	2,375	125	500
Share of B Ltd. (4/6)	9,500	500	2,000

(3) Analysis of Profits of B Ltd.

	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue profit* ₹
Reserves on 30.9.2016	9,000		
Profit and Loss A/c on 30.9.2016	8,000		
Increase in reserves		1,000	
Increase in profit			4,000
Share in C Ltd. [WN 1]		500	2,000
	17,000	1,500	6,000
Less: Minority interest (2/10)	(3,400)	(300)	(1,200)
Share of A Ltd. (8/10)	13,600	1,200	4,800

(4) Cost of control

	₹	₹
Investments in		
B Ltd.	95,000	
C Ltd. [13,000 + 53,000]	66,000	1,61,000
Less : Paid up value of investments in		
B Ltd.	80,000	
C Ltd.	50,000	(1,30,000)
Capital profits in		
B Ltd. [WN 3]	13,600	
C Ltd. [WN 2]	11,875	(25,475)
Goodwill		5,525

(5) Minority Interest

	₹	₹
Share Capital:		
B Ltd. [20 %]	20,000	
C Ltd. [1/6th]	10,000	30,000
Share in profits and reserves (Pre and Post-Acquisitions)		
B Ltd. [WN 3]	4,900	
C Ltd. [WN 2]	3,000	7,900
		37,900
Less: Provision for unrealized profit (20% of ₹ 400)		(80)
		37,820
Less: Dividend payable B	2,000	
C	1,000	3,000
		34,820

Note: The above solution has been done by direct method. Alternatively, students may follow indirect method. In indirect method, the share in pre-acquisition profits of B Ltd. in C Ltd. amounting ₹ 9,500 will be included as capital profit while analysing the profits of B Ltd. and will not be considered for the purpose of cost of control. Thus, in this case, the amounts of goodwill and minority interest will increase by ₹ 1,900 (2/10 of ₹ 9,500). Goodwill and minority interest will be shown at ₹ 7,425 and ₹ 39,720 respectively in the consolidated balance sheet. Therefore, the total of the assets and liabilities side of the consolidated balance sheet will be ₹ 2,22,025.

Question 12

The following are the summarized Balance Sheets of Arun Ltd., Brown Ltd. and Crown Ltd. as at 31.3.2017:

Liabilities:	Arun Ltd. ₹	Brown Ltd. ₹	Crown Ltd. ₹
Share Capital (Shares of ₹ 100 each)	6,00,000	4,00,000	2,40,000
Reserves	80,000	40,000	30,000
Profit and Loss Account	2,00,000	1,20,000	1,00,000
Trade payables	80,000	1,00,000	60,000
Arun Ltd.	--	40,000	32,000
Total	9,60,000	7,00,000	4,62,000
Assets:	**Arun Ltd. ₹**	**Brown Ltd. ₹**	**Crown Ltd. ₹**
Goodwill	80,000	60,000	40,000
Fixed Assets	2,80,000	2,00,000	2,40,000
Shares in:			
Brown Ltd. (3,000 Shares)	3,60,000	--	--
Crown Ltd. (400 Shares)	60,000	--	--
Crown Ltd. (1,400 Shares)	--	2,08,000	--
Due from: Brown Ltd.	48,000	--	--
Crown Ltd.	32,000	--	--
Current Assets	1,00,000	2,32,000	1,82,000
Total	9,60,000	7,00,000	4,62,000

(i) All shares were acquired on 1.10.2016.

(ii) On 1.4.2016 the balances to the various accounts were as under:

Particulars	Arun Ltd. ₹	Brown Ltd. ₹	Crown Ltd. ₹
Reserves	40,000	40,000	20,000
Profit and Loss account	20,000	(Dr.) 20,000	12,000

(iii) During 2016-2017, Profits accrued evenly.

(iv) In November, 2016, each company paid interim dividend of 10%. Arun Ltd. and Brown Ltd. have credited their profit and loss account with the dividends received.

(v) During 2016-2017, Crown Ltd. sold an equipment costing ₹ 40,000 to Brown Ltd. for ₹ 48,000 and Brown Ltd. in turn sold the same to Arun Ltd. for ₹ 52,000.

Prepare the consolidated Balance Sheet as at 31.3.2017 of Arun Ltd. and its subsidiaries.

Answer

Consolidated Balance Sheet of Arun Ltd. and its subsidiaries as on 31.3.2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	6,00,000
(b) Reserves and Surplus	2	3,37,271
(2) **Minority Interest (W.N.4)**		2,33,729
(3) **Current Liabilities**		
Trade payables		2,40,000
Total		14,11,000
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
i. Tangible assets		7,08,000
ii. Intangible assets	3	1,81,000
(2) **Current assets**		
(a) Cash and cash equivalents	4	8,000
(b) Other current assets		5,14,000
Total		14,11,000

Notes to Accounts

		(₹)	*(₹)*
1.	Share Capital		
	Shares of ₹ 100 each		6,00,000
2.	Reserves and surplus		
	Reserves (W. N. 8)	83,021	
	Profit & Loss A/c (W. N. 8)	2,54,250	3,37,271
3.	Intangible assets		
	Goodwill (W.N.5)		1,81,000
4.	Cash and cash equivalents		
	Cash in Transit (W.N.7)		8,000

Working Notes

1. Shareholding Pattern

In Brown Ltd.:	*Number of Shares*	*% age of Holding*
Arun Ltd.	3,000	75%
Minority Interest	1,000	25%
In Crown Ltd.:		
Arun Ltd.	400	16.667%
Brown Ltd.	1,400	58.333%
Minority Interest	600	25%

2. Analysis of apportionment of profit in Crown Ltd.

(a) Calculation of Unrealized Profit in Equipment

Crown Ltd sold equipment to Brown Ltd. at a profit of ₹ 8,000 and this would be apportioned to

	₹
Arun Ltd.	1,333
Brown Ltd.	4,667
Minority Interest	2,000
	8,000

Brown Ltd sold the equipment to Arun Ltd. at a profit of ₹ 4,000. This would be apportioned to:

	₹
Arun Ltd.	3,000
Minority Interest	1,000
	4,000

The above amounts are to be deducted from the respective share of profits.

(b) *Reserves*

	₹	
Closing balance	30,000	
Opening balance	20,000	Capital Profit
Current year Appropriation	10,000	
Apportionment of Profit from 1.4.2016 to 30.9.2016	5,000	Capital Profit
Apportionment of Profit from 1.10.2016 to 31.3.2017	5,000	Revenue Reserve

(c) *Profit and Loss Account*

Closing balance	1,00,000	
Add: Interim Dividend	24,000	
Less: Opening balance	12,000	Capital Profit
Current year profits before interim dividend	1,12,000	
Apportionment of Profit from 1.4.2016 to 30.9.2016	56,000	
Less: Interim Dividend [2,40,000 x 10 %]	(24,000)	
	32,000	Capital Profit
From 1.10.2016 to 31.3.2017	56,000	Revenue Profit

(d) *Apportionment of profits of Crown Ltd.*

	Pre-acquisition	**Post-acquisition**	
	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
Reserves	25,000	5,000	--
Profit & Loss Account	44,000	--	56,000
	69,000	5,000	56,000
Arun Ltd [16.667%]	11,500	833	9,333
Brown Ltd. [58.333%]	40,250	2,917	32,667
Minority Interest [25%]	17,250	1,250	14,000

3. Analysis of Profit of Brown Ltd

(a) Reserves

	₹	
Closing balance	40,000	
Opening balance	40,000	(Capital Profit)
Current year Appropriation	Nil	

(b) *Profit and Loss Account*

	₹
Closing balance	1,20,000
Opening balance (Dr.)	20,000
Current year Appropriation after interim dividend	1,40,000
Interim Dividend	40,000
Profit before Interim Dividend	1,80,000
Less: Dividend received from Crown Ltd.	(14,000)

	1,66,000
Apportionment of Profit from 1.4.2016 to 30.9.2016	83,000
Less: Interim Dividend	(40,000)
Capital profit	43,000
Apportionment of Profit from 1.10.2016 to 31.3.2017 (Revenue profit)	83,000

(c) *Apportionment of Profit of Brown Ltd.*

	Pre-Acquisition	Post-Acquisition	
	Capital Profit ₹	*Revenue Reserve* ₹	*Revenue Profit* ₹
Reserves	40,000	--	--
Profit & Loss Account (Opening balance (-) 20,000+43,000)	23,000		83,000
Less: Unrealised Profit of Equipment from Crown Ltd.			(4,667)
Share of Post-Acquisition Profit of Crown Ltd.	--	2,917	32,667
	63,000	2,917	1,11,000
Arun Ltd. 75%	47,250	2,188	83,250
Minority Interest 25%	15,750	729	27,750

4. Minority Interest

	Brown Ltd. ₹	*Crown Ltd.* ₹
Share Capital	1,00,000	60,000
Capital Profit	15,750	17,250
Revenue: Reserves	729	1,250
Profit & Loss Account	27,750	14,000
Unrealised Profit on Equipment	(1,000)	(2,000)
	1,43,229	90,500
Total Minority Interest: ₹ 1,43,229+ ₹ 90,500 = ₹ 2,33,729		

5. Cost of Control

	Arun Ltd. in Brown Ltd. ₹	*Arun Ltd. in Crown Ltd.* ₹	*Brown Ltd in Crown Ltd.* ₹
Amount Invested	3,60,000	60,000	2,08,000
Less: Pre-acquisition dividend*	(30,000)	(4,000)	(14,000)
Adjusted Cost of Investment (A)	3,30,000	56,000	1,94,000
Share capital	3,00,000	40,000	1,40,000
Capital Profit	47,250	11,500	40,250
(B)	3,47,250	51,500	1,80,250
Capital Reserve/Goodwill (A)-(B)	(17,250)	4,500	13,750
Net Goodwill	₹1,000		
Goodwill on Consolidation ₹ (80,000+ 60,000+40,000+1,000) = ₹1,81,000			

6. Dividend declared

	Brown Ltd. ₹	*Crown Ltd.* ₹
Dividend declared	40,000	24,000
Share of: Arun Ltd.	30,000	4,000
Brown Ltd.		14,000
Minority	10,000	6,000

7. Inter-Company Transactions

(a) Owings

	Dr. *Arun Ltd.* ₹	*Cr.* *Brown Ltd.* ₹	*Cr.* *Crown Ltd.* ₹
Balance in books	80,000	40,000	32,000
Less: Inter- co. owings	(72,000)	(40,000)	(32,000)
Cash-in-transit	8,000	NIL	NIL

(b) Fixed Assets

	₹
Total Fixed Assets	7,20,000

* The entire amount of interim dividend of 10% has been treated as pre-acquisition dividend.

Less: Unrealised Profit on sale of equipment	(12,000)
Amount to be taken to consolidated Balance Sheet	7,08,000

8. Reserves and Profit and Loss Account balances in the Consolidated Balance Sheet

	Reserves ₹	*Profit and Loss A/c* ₹
Balance in Books	80,000	2,00,000
Add: Shares of Post-acquisition Profits:		
From Brown Ltd.	2,188	83,250
From Crown Ltd	833	9,333
Less: Pre-Acquisition dividend:		
From Brown Ltd.		(30,000)
From Crown Ltd		(4,000)
Less: Unrealised Profit on Equipment:		
From Brown Ltd.		(3,000)
From Crown Ltd.		(1,333)
	83,021	2,54,250

Question 13

The following information has been extracted from the Books of 'X' Limited group (as at 31st March, 2017):

	X Ltd. ₹	*Y Ltd.* ₹	*Z Ltd.* ₹		*X Ltd.* ₹	*Y Ltd.* ₹	*Z Ltd.* ₹
Share capital				*Fixed Assets less depreciation*	*4,20,000*	*3,76,000*	*5,22,000*
(Fully paid equity shares of ₹ 10 each)	*8,00,000*	*6,00,000*	*4,00,000*	*Investment at cost*	*6,30,000*	*4,00,000*	*--*
				Current Assets	*1,20,000*	*60,000*	*40,000*
Profit and Loss Account	*2,10,000*	*1,90,000*	*1,28,000*				
Dividend received:							
From Y Ltd. in 2015-2016	*60,000*						
From Y Ltd. in 2016-2017	*60,000*						
From Z Ltd. in		*36,000*					

2016-2017							
Current Liabilities	*40,000*	*10,000*	*34,000*				
	11,70,000	*8,36,000*	*5,62,000*		*11,70,000*	*8,36,000*	*5,62,000*

All the companies pay dividends of 12 percent of paid-up share capital in June following the end of the financial year. The receiving companies account for the dividends in their books when they are received.

'X' Limited acquired 50,000 equity shares of Y Ltd. on 31st March, 2015.

'Y' Limited acquired 30,000 equity shares of Z Ltd. on 31st March, 2016.

The detailed information of Profit and Loss Accounts is as follows:

	X Ltd. ₹	*Y Ltd.* ₹	*Z Ltd.* ₹
Balance of Profit and Loss Account on 31st March, 2015 after dividends of 12% in respect of financial year 2014-2015, but excluding dividends received	*86,000*	*78,000*	*60,000*
Net profit earned in 2015-2016	*1,20,000*	*84,000*	*56,000*
	2,06,000	*1,62,000*	*1,16,000*
Less – Dividends of 12% (paid in 2016-2017)	*96,000*	*72,000*	*48,000*
	1,10,000	*90,000*	*68,000*
Net profit earned in 2016-2017 (Before taking into account dividends of 12% in respect of financial year 2016-2017)	*1,00,000*	*1,00,000*	*60,000*
	2,10,000	*1,90,000*	*1,28,000*

Taking into account the transactions from 2014-2015 to 2016-2017 and ignoring taxation, you are required to prepare:

(i) The Consolidated Balance Sheet of X Limited group as at 31st March, 2017.

(ii) Cost of control.

(iii) Minority shareholders interest.

Answer

(i) Consolidated Balance Sheet of X Ltd. and its subsidiaries Y Ltd. and Z Ltd. as on 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	8,00,000

		(b) Reserves and Surplus	2	3,04,833
	(2)	**Minority Interest** [Refer (iii)]		2,47,167
	(3)	**Current Liabilities**		
		(a) Trade payables	3	84,000
		(b) Other current liabilities	4	1,20,000
		Total		15,56,000
II.	**Assets**			
	(1)	**Non-current assets**		
		Fixed assets		
		i. Tangible assets	5	13,18,000
		ii. Intangible assets	6	18,000
	(2)	**Current assets**		2,20,000
		Total		15,56,000

Notes to Accounts

				(₹)	(₹)
1.	Share Capital				
	80,000 Equity shares of ₹10 each fully paid				8,00,000
2.	Reserves and surplus				
	Profit and Loss Account				
	Opening balance		₹		
		X Ltd	2,06,000		
		Y Ltd	1,62,000		
		Z Ltd	1,16,000	4,84,000	
	Add: Dividend received in 2015-2016 (for 2014-2015)				
		X Ltd	60,000		
		Y Ltd	-----		
		Z Ltd	-----	60,000	
				5,44,000	
	Less: Dividend paid for 2015-2016				
		X Ltd	96,000		
		Y Ltd	72,000		
		Z Ltd	48,000		
		Less: Adjustments	(96,000)	(1,20,000)	
				4,24,000	
	Add: Dividend received in 2016-2017 (for 2015-2016)				
		X Ltd	60,000		

	Y Ltd	36,000		
	Z Ltd	-----		
	Less: Adjustments	(96,000)	-	
			4,24,000	
	Add: Profit for the year			
	X Ltd	1,00,000		
	Y Ltd	1,00,000		
	Z Ltd	60,000	2,60,000	
			6,84,000	
	Less: Minority Interest			
	X Ltd	-----		
	Y Ltd	39,167		
	Z Ltd	32,000	(71,167)	
			6,12,833	
	Less: Capital reserve (cost of control)			
	X Ltd	65,000		
	Y Ltd	51,000		
	Z Ltd	----	(1,16,000)	
			4,96,833	
	Less: Dividend received out of capital profit			
	X Ltd	60,000*		
	Y Ltd	36,000*		
	Z Ltd	-----	(96,000)	
			4,00,833	
	Less: Dividend			
	X Ltd	96,000		
	Y Ltd	-----		
	Z Ltd	-----	(96,000)	
	Closing balance of Profit (Bal fig)		3,04,833	
	Share of X Ltd. (Bal fig)	1,74,000		
	Share of Y Ltd (Bal fig)	85,833		
	Share of Z Ltd (Bal fig)	45,000		3,04,833
3.	Trade Payables			84,000
4.	Other current liabilities			
	Dividend payable of X Ltd.		96,000	

	Y Ltd.	12,000	
	Z Ltd.	12,000	1,20,000
5.	Tangible Assets		
	Fixed Assets less depreciation		13,18,000
6.	Intangible assets		
	Goodwill [Refer (ii)]		18,000

Notes:*

(1) X Ltd. receives from Y Ltd., dividend amounting to ₹60,000 for the year 2014-2015 in the year 2015-2016 for shares acquired in 2014-2015. It is a capital profit, therefore it has been transferred to cost of control to reduce the cost of investment.

(2) Y Ltd. receives a dividend of ₹ 36,000 from Z Ltd. for the year 2015-2016 in the year 2016-2017. The shares were acquired by Y Ltd on 31st March, 2016. The entire amount is therefore, a capital profit and hence transferred to cost of control to reduce the cost of investment.

(ii) Cost of Control:

	₹	₹
Cost of Investment in Y Ltd. on 31st March, 2015	6,30,000	
Less: Dividend of the year 2014-2015 received in 2015-2016 out of Pre-acquisition profit	(60,000)	5,70,000
Cost of Investment in Z Ltd.	4,00,000	
Less: Dividend of the year 2015-2016 received in 2016-2017 out of Pre-acquisition Profit	(36,000)	3,64,000
		9,34,000
Less: Paid up value of shares in Y Ltd.	5,00,000	
Paid up value of shares in Z Ltd.	3,00,000	
Capital Profits in Y Ltd. (Refer W.N. 2)	65,000	
Capital Profits in Z Ltd. (Refer W.N. 2)	51,000	(9,16,000)
Goodwill		18,000

(iii) Minority shareholders' interest:

	Y Ltd. ₹	*Z Ltd.* ₹
Share Capital (Y Ltd. – 1/6 and Z Ltd. – 1/4)	1,00,000	1,00,000
Capital Profits (Refer W.N. 2)	13,000	17,000

Revenue Profits (Refer W.N. 2)	26,167	15,000
	1,39,167	1,32,000
Total (1,39,167 + 1,32,000)		2,71,167
Less: Dividend payable		
Y Ltd.	12,000	
Z Ltd.	12,000	24,000
		2,47,167

Working Notes:

1. **Shareholding Pattern**

	Number of shares	*Share of holding*
In Y Ltd.		
X Ltd.	50,000	5/6
Minority Interest	10,000	1/6
In Z Ltd.		
Y Ltd.	30,000	3/4
Minority Interest	10,000	1/4

2. **Analysis of Profits**

	Pre - acquisition Capital Profit	*Post - acquisition Revenue Profit*
Z Ltd.	₹	₹
Balance on 31st March, 2016 after dividend for 2015-2016 (₹1,16,000 – ₹48,000)	68,000	-
Profit for the year ending 31st March, 2017 before dividends for 2016-2017	-	60,000
	68,000	60,000
Share of Y Ltd. (3/4)	51,000	45,000
Minority Interest (1/4)	17,000	15,000
Y Ltd.		
Balance on 31st March, 2015	78,000	-
Profit for the year 2015-2016 after payment of dividend for 2015-2016 (₹84,000 – ₹72,000)	-	12,000

Profit for the year 2016-2017 (before payment of dividend of the year 2016-2017)	-	1,00,000
Revenue Profit from Z Ltd.	-	45,000
	78,000	1,57,000
Share of X Ltd. (5/6)	65,000	1,30,833
Share of Minority Shareholders' Interest (1/6)	13,000	26,167

Note: This problem has been solved by following 'direct approach'.

Question 14

The draft Balance Sheets of 3 Companies as at 31st March, 2017 are as below:

	(In ₹ 000's)		
Liabilities	*Morning Ltd.*	*Evening Ltd.*	*Night Ltd.*
Share Capital – shares of ₹ 100 each	*40,000*	*20,000*	*10,000*
Reserves	*1,800*	*1,000*	*900*
P/L A/c (1.4.2016)	*1,500*	*2,000*	*800*
Profit for 2016-15	*7,000*	*3,800*	*1,800*
Loan from Morning Ltd.	–	*5,000*	–-
Trade payables	*2,500*	*1,000*	*1,400*
	52,800	*32,800*	*14,900*
Assets			
Investments:			
1,60,000 shares in Evening	*18,000*	–	–
75,000 shares in Night	*8,000*	–	–
Loan to Evening Ltd.	*5,000*	–	–
Tangible assets	*21,800*	*32,800*	*14,900*
	52,800	*32,800*	*14,900*

Following additional information is also available:

(a) *Dividend is declared by each company at 10%.*

(b) *Inventory transferred by Night Ltd. to Evening Ltd. fully paid for was ₹ 8 lacs on which the former made a Profit of ₹ 3 lacs. On 31st March, 2017, this was in the inventory of the latter.*

(c) *Loan referred to is against 8% interest. Neither Morning Ltd. nor Evening Ltd. has considered the interest.*

(d) Reserves as on 1.4.2016 of Evening Ltd. and Night Ltd. were ₹ 8,00,000 and ₹ 7,50,000 respectively.

(e) Cash-in-transit from Evening Ltd. to Morning Ltd. was ₹ 1,00,000 as on 31.3.2017.

(f) The shares of the subsidiaries were all acquired by Morning Ltd. on 1st April, 2016.

Prepare Consolidated Balance Sheet as on 31st March, 2017. Workings should be part of the answer.

Answer

Consolidated Balance Sheet of Morning Ltd.
with its subsidiaries Evening Ltd. and Night Ltd.
As on 31st March, 2017

Particulars	*Note No.*	*(₹ in thousand)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital		40,000
(b) Reserves and Surplus	1	11,720
(2) **Minority Interest**	2	7,930
(3) **Current Liabilities**		
(a) Trade payables	3	4,900
(b) Other current liabilities	4	4,650
Total		69,200
II. **Assets**		
Non-current assets		
Fixed assets		
Tangible assets	5	69,200
Total		69,200

Notes to Accounts

			(₹ in thousand)	*(₹ in thousand)*
1.	Reserves and surplus			
	Capital Reserve [Refer Note 5]		902.5	
	General Reserve	₹		
	Morning Ltd.	1,800		
	Evening Ltd.	160		
	Night Ltd.	112.5	2,072.5	

	Profit & Loss A/c	₹		
	Balance on 1.04.2016	1,500		
	Profit during 2016-2017	7,000		
	Add: Interest on Loan	400		
		8,900		
	Less: Dividend	(4,000)		
		4,900		
	Add: P & L A/c of Evening Ltd.	2,720		
	Add: P & L A/c of Night Ltd.	1,125	8,745	11,720
2.	Minority interest			
	Evening Ltd.		4,880	
	Night Ltd.		3,050	7,930
3.	Trade payables			
	Morning Ltd.		2,500	
	Evening Ltd.		1,000	
	Night Ltd		1,400	4,900
4.	Other current liabilities			
	Dividend payable			
	Morning Ltd.		4,000	
	Evening Ltd. (Minority)		400	
	Night Ltd. (Minority)		250	4,650
5.	Tangible assets			
	Morning Ltd.		21,800	
	Evening Ltd.	32,800		
	Less: Unrealized profit Night Ltd.	(300)	32,500	
	Night Ltd.		14,900	69,200

Workings Notes:

A. Morning Ltd.'s holding in Evening Ltd. is 1,60,000 shares out of 2,00,000 shares, i.e., 4/5th or 80%; Minority holding 1/5th or 20%.

B. Morning Ltd.'s holding in Night Ltd. is 75,000 shares out of 1,00,000 shares, i.e., 3/4th or 75%; Minority holding 1/4th or 25%.

Analysis of Reserves and Profits of Subsidiary Companies

		Evening Ltd. (₹'000)	*Night Ltd ₹ ('000)*	*Minority interest in Evening Ltd. (1/5) ₹ ('000)*	*Minority interest in Night Ltd. (1/4) ₹ ('000)*
1.	**Capital Reserve (pre-acquisition reserves and profits)**				
	Reserves on 1.04.2016	800	750		
	Profit on 1.04.2016	2,000	800		
		2,800	1,550		
	Less: Minority interest	(560)	(387.5)	560	387.5
		2,240	1,162.5		
2.	**General Reserve**				
	Reserves as per Balance Sheet	1,000	900		
	Less: Capital Reserve	(800)	(750)		
		200	150		
	Less: Minority interest	(40)	(37.5)	40	37.5
		160	112.5		
3.	**Profit and Loss Account**				
	Profit for the year as per Balance Sheet	3,800	1,800		
	Less: Interest on Loan (5,000 x 8%)	(400)			
		3,400			
	Less: Minority Interest	(680)	(450)	680	450
		2,720	1,350		
	Less: Unrealised profit on inventory transfer	___	(225*)		(75)
		2,720	1,125		
4.	**Share Capital**				
	As per Balance sheet	20,000	10,000		
	Less: Minority interest	(4,000)	(2,500)	4,000	2,500

* As per para 17 of AS 21, 'Unrealised profits resulting from intragroup transactions that are included in the carrying amount of assets, such as inventory and fixed assets, are eliminated in full.

	Transferred for computation of Goodwill/Capital Reserve	16,000	7,500	5,280	3,300
	Less: Dividend shown separately			(400)	(250)
	Transferred to Consolidated Balance Sheet			4,880	3,050

5. Computation of Cost of Control i.e. Goodwill / Capital Reserve on consolidation

(₹ In thousand)

	Evening Ltd.	*Night Ltd.*
Cost of Investments	18,000	8,000
Less: Paid up value of shares [Refer Note 4]	(16,000)	7,500
	2,000	500
Less: Capital Reserve [Refer Note 1]	(2,240)	(1,162.5)
	(-240)	(-662.5)
Total Capital Reserve (₹ 240 + ₹ 662.5)	902.5	

Question 15

The summarized Balance Sheets of three companies Angle Ltd., Bolt Ltd., and Canopy Ltd., as at 31st March, 2017 are given below:

Liabilities	*Angle Ltd.* ₹	*Bolt Ltd.* ₹	*Canopy Ltd.* ₹
Share capital			
(Equity shares of ₹ 100 each)	*15,00,000*	*10,00,000*	*6,00,000*
Reserves	*2,00,000*	*1,25,000*	*75,000*
Profit and Loss A/c	*5,00,000*	*2,75,000*	*2,50,000*
Trade payables	*2,00,000*	*2,50,000*	*1,50,000*
Angle Ltd.	-	*1,00,000*	*80,000*
	24,00,000	*17,50,000*	*11,55,000*
Goodwill	*2,50,000*	*5,80,000*	*4,50,000*
Plant and Machinery	*4,00,000*	*2,50,000*	*3,25,000*
Furniture and Fittings	*2,00,000*	*1,50,000*	*1,40,000*
Shares in-			
Bolt Ltd. (7,500 shares)	*9,00,000*	-	-
Canopy Ltd. (1,000 shares)	*1,50,000*		
Canopy Ltd. (3,500 shares)	-	*5,20,000*	-
Inventory in trade	*1,00,000*	*1,50,000*	*1,60,000*
Trade receivables	*1,90,000*	*90,000*	*70,000*

Due from-			
Bolt Ltd.	*1,20,000*	-	-
Canopy Ltd.	*80,000*	-	-
Cash in hand	*10,000*	*10,000*	*10,000*
Total	*24,00,000*	*17,50,000*	*11,55,000*

(a) All shares were acquired on 1st October, 2015.

(b) On 1st April, 2015, the balances were:

	Angle Ltd.	*Bolt Ltd.*	*Canopy Ltd.*
	₹	₹	₹
Reserves	*1,00,000*	*1,00,000*	*50,000*
Profit and Loss account	*50,000*	*(50,000)Dr.*	*30,000*
Profit during 2015-2016 were earned evenly over the year	*3,00,000*	*2,50,000*	*1,00,000*

(c) Each company declared a dividend of 10% in the year 2016-2017 on its shares out of Profits for the year 2015-2016; Angle Ltd. and Bolt Ltd. have credited their Profit and Loss account with the dividends received.

(d) The increase in reserves in case of Angle Ltd., Bolt Ltd., and Canopy Ltd., was effected in the year 2015-2016.

(e) Details of Trade payables and Trade receivables:

	Angle Ltd.	*Bolt Ltd.*	*Canopy Ltd.*
Trade payables			
Bills Payable	-	-	*50,000*
Sundry creditors	*2,00,000*	*2,50,000*	*1,00,000*
	2,00,000	*2,50,000*	*1,50,000*
Trade receivables			
Debtors	*1,40,000*	*70,000*	*70,000*
Bills Receivables	*50,000*	*20,000*	-
	1,90,000	*90,000*	*70,000*

(f) All the bills payable appearing in Canopy Ltd.'s Balance Sheet were accepted in favour of Bolt Ltd., out of which bills amounting ₹ 30,000 were endorsed by Bolt Ltd., in favour of Angle Ltd.

(g) Inventory with Bolt Ltd. includes goods purchased from Angle Ltd., for ₹ 18,000. Angle Ltd., invoiced the goods at cost plus 20%.

Prepare consolidated Balance Sheet of the group as at 31st March, 2017. Working should be part of the answer. Ignore taxation including dividend distribution tax, disclose minority interest as per AS 21.

Answer

Consolidated Balance Sheet of Angle Ltd. and its subsidiaries Bolt Ltd and Canopy Ltd as at 31st March, 2017

Particulars	*Note No.*	*(₹)*
I. **Equity and Liabilities**		
(1) **Shareholder's Funds**		
(a) Share Capital	1	15,00,000
(b) Reserves and Surplus	2	9,83,562
(2) **Minority Interest**	3	6,24,271
(3) **Current Liabilities**		
Trade payables	4	5,50,000
Total		36,57,833
II. **Assets**		
(1) **Non-current assets**		
Fixed assets		
i. Tangible assets	5	14,65,000
ii. Intangible assets	6	14,35,833
(2) **Current assets**		
(a) Inventories	7	4,07,000
(b) Trade receivables	8	3,00,000
(c) Cash and cash equivalents	9	50,000
Total		36,57,833

Notes to Accounts

		(₹)	*(₹)*
1.	Share Capital		
	Equity shares of ₹ 100 each		15,00,000
2.	Reserves & surplus		
	Reserves (2,00,000+14,844+2,083)	2,16,927	
	Profit and Loss Account (W.N.4)	7,66,635	9,83,562

3.	Minority Interest (W.N. 6)			
	Bolt Ltd.		3,93,021	
	Canopy Ltd.		2,31,250	6,24,271
4.	Trade payables			
	Angle Ltd.	2,00,000		
	Bolt Ltd.	2,50,000		
	Canopy Ltd.	1,50,000	6,00,000	
	Less: Mutually held		(50,000)	5,50,000
5.	Tangible Assets			
	Plant & Machinery			
	Angle Ltd.	4,00,000		
	Bolt Ltd.	2,50,000		
	Canopy Ltd.	3,25,000	9,75,000	
	Furniture & Fittings			
	Angle Ltd.	2,00,000		
	Bolt Ltd.	1,50,000		
	Canopy Ltd	1,40,000	4,90,000	14,65,000
6.	Intangible assets			
	Goodwill			
	Angle Ltd.	2,50,000		
	Bolt Ltd.	5,80,000		
	Canopy Ltd.	4,50,000	12,80,000	
	Add: Cost of control (W.N.7)		1,55,833	14,35,833
7.	Inventories			
	Inventory-in-trade			
	Angle Ltd.		1,00,000	
	Bolt Ltd.		1,50,000	
	Canopy Ltd.		1,60,000	
			4,10,000	
	Less: Provision for unrealised profit		(3,000)	4,07,000
8.	Trade receivables			
	Angle Ltd.	1,90,000		
	Bolt Ltd.	90,000		
	Canopy Ltd.	70,000	3,50,000	
	Less: Mutually held		(50,000)	3,00,000
9.	Cash and cash equivalents			
	Cash-in-hand			
	Angle Ltd.	10,000		

	Bolt Ltd.	10,000		
	Canopy Ltd.	10,000	30,000	
	Cash-in-Transit/ Dues from Bolt Ltd. (W.N.8)		20,000	50,000

Working Notes:

Shareholding Pattern

	Bolt Ltd.	*Canopy Ltd.*
Total Shares	10,000	6,000
Held By Angle Ltd.	7,500 (75%)	1,000 (2/12th)
Held by Bolt Ltd.	NA	3,500 (7/12th)
Minority Interest	2,500 (25%)	1,500 (3/12th)

1. Ascertainment of Profits for the year 2016-2017

	Angle Ltd. ₹	*Bolt Ltd.* ₹	*Canopy Ltd.* ₹
Balance as on 1st April, 2015	50,000	(50,000)	30,000
Add: Profits earned during 2015-2016	3,00,000	2,50,000	1,00,000
	3,50,000	2,00,000	1,30,000
Less: Dividend Declared	(1,50,000)	(1,00,000)	(60,000)
	2,00,000	1,00,000	70,000
Less: Transfer to Reserve	(1,00,000)	(25,000)	(25,000)
	1,00,000	75,000	45,000
Profit for the year 2016-2017 (Balancing Figure)	4,00,000	2,00,000	2,05,000
Balance as on 31st March, 2017	5,00,000	2,75,000	2,50,000
Less: Pre-acquisition dividend wrongly credited	42,500	17,500	-
Correct balance as on 31st March, 2017	4,57,500	2,57,500	2,50,000

2. Undistributed profits for the year 2015-2016

	Bolt Ltd. ₹	*Canopy Ltd.* ₹
Profits for the year 2015-2016	2,50,000	1,00,000
Less: Dividends declared	(1,00,000)	(60,000)
	1,50,000	40,000
Less: Transfer to Reserves	(25,000)	(25,000)
	1,25,000	15,000

3. Analysis of Profits

	Capital Profits ₹	Revenue Reserve ₹	Revenue Profits ₹
Canopy Ltd.			
Reserves as on 1st April, 2015	50,000		
Transfer to Reserve in the year 2015-2016 [(75,000-50,000)/2]	12,500	12,500	
Profit & Loss Account			
Balance as on 1st April, 2015	30,000		
Profit for 2015-2016 remaining undistributed [(1,00,000-25,000-60,000)/2]	7,500		7,500
Profit for the year 2016-2017 (2,50,000-30,000-15,000)			2,05,000
(A)	1,00,000	12,500	2,12,500
Minority Interest [¼ th of (A)]	25,000	3,125	53,125
	75,000	9,375	1,59,375
Share of Angle Ltd. [1/6 th of (A)]	16,667	2,083	35,417
Share of Bolt Ltd.	58,333	7,292	1,23,958
Bolt Ltd.			
Reserves as on 1st April, 2015	1,00,000		
Transfer to Reserves 2015-2016 [(1,25,000-1,00,000)/2]	12,500	12,500	
Profit & Loss Account - Balance (Dr.) as on 1st April, 2015	(50,000)		
Undistributed Profits for 2015-2016 [(2,50,000-25,000-1,00,000)/2]	62,500		62,500
Share in profits of Canopy Ltd.	58,333	7,292	1,23,958
Profit for the year, 2016-2017 (2,00,000 – 17,500)			1,82,500
(B)	1,83,333	19,792	3,68,958
Less: Minority Interest [¼ th of (B)]	(45,833)	(4,948)	(92,240)
Share of Angle Ltd.	1,37,500	14,844	2,76,718

4. Consolidated Profit and Loss Account of Angle Ltd.

	₹
Profit & Loss Account balance as on 31.3.2017	4,57,500
Add: Share in revenue profits of Canopy Ltd. [WN 3]	35,417
Share in revenue profits of Bolt Ltd. [WN 3]	2,76,718
	7,69,635
Less: Unrealised Profit in Closing Inventory (20/120 × 18,000)	(3,000)
	7,66,635

5. Consolidated Reserves of Angle Ltd.

	₹
Reserves as on 31.3.2017	2,00,000
Add: Share in revenue reserves of Canopy Ltd.	2,083
Add: Share in revenue reserves of Bolt Ltd.	14,844
	2,16,927

6. Minority Interest

	Bolt Ltd.	*Canopy Ltd.*
	₹	₹
Share Capital	2,50,000	1,50,000
Share of Capital Profits	45,833	25,000
Share of Revenue Reserves	4,948	3,125
Share of Revenue Profits	92,240	53,125
Total	3,93,021	2,31,250
Grand total		6,24,271

7. Cost of Control/Goodwill

	₹	₹
Cost of investments (9,00,000+1,50,000+5,20,000)		15,70,000
Less: Dividend Attributable to Pre-Acquisition Profits for 6 months i.e. [(75,000+45,000)/2]		(60,000)
		15,10,000
Less: Face value of Shares		
Bolt Ltd.	7,50,000	
Canopy Ltd.	4,50,000	
Capital Profits		
Bolt Ltd.	1,37,500	

Canopy Ltd.	16,667	(13,54,167)
Goodwill		1,55,833

8 Cash in Transit /Dues from Bolt Ltd.

		₹	₹
(i)	Due to Angle Ltd.		
	From Bolt Ltd.	1,20,000	
	From Canopy Ltd.	80,000	2,00,000
(ii)	Due by Angle Ltd.		
	To Bolt Ltd.	1,00,000	
	To Canopy Ltd.	80,000	1,80,000
			20,000

Question 16

The following are the summarized Balance Sheets of Ram Ltd., Shyam Ltd. and Tom Ltd. as on 31.03.2017:

	₹ in'000		
Particulars	*Ram Ltd.*	*Shyam Ltd.*	*Tom Ltd.*
Liabilities			
Equity Share Capital (₹ 100 each)	*8,000*	*4,000*	*1,600*
General Reserve	*1,600*	*280*	*-*
Profit and Loss Account	*1,360*	*960*	*-*
Current Liabilities	*1,280*	*3,000*	*1,120*
Total	*12,240*	*8,240*	*2,720*
Assets			
Investments:			
32,000, shares in Shyam Ltd.	*4,800*	*-*	*-*
4,000, shares in Tom Ltd.	*200*	*-*	*-*
12,000, shares in Tom Ltd.	*-*	*720*	*-*
Profit and Loss Account	*-*	*-*	*640*
Current Assets	*7,240*	*7,520*	*2,080*
Total	*12,240*	*8,240*	*2,720*

From the following information, prepare consolidated Balance Sheet of Ram Ltd. and its subsidiaries as on 31.03.2017:

(i) Shyam Ltd. has advanced ₹ 8,00,000 to Tom Ltd.

(ii) Current Liabilities of Ram Ltd. includes ₹ 4,00,000 due to Tom Ltd.

(iii) Shyam Ltd. and Tom Ltd. have not paid any dividend.

(iv) Ram Ltd. acquired its investments on 01.04.2016 from Shyam Ltd. and then amount standing to credit of General Reserve and Profit and Loss account were ₹ 2,80,000 and ₹ 5,20,000 respectively.

(v) Ram Ltd. acquired investments in Tom Ltd. on 01.04.2016, when the debit balance in Profit and Loss account in books of Tom Ltd. was ₹ 4,80,000.

(vi) Shyam Ltd. acquired its investments in Tom Ltd. on 01.04.2014 and then the debit balance in Profit and Loss account was ₹ 1,60,000.

(vii) Shyam Ltd.'s inventory includes inventory worth ₹ 4,80,000 which was invoiced by Ram Ltd. at 20% above cost.

Answer

Consolidated Balance Sheet of Ram Ltd. and its subsidiaries Shyam Ltd and Tom Ltd. as on 31.3.2017

Particulars	*Note No.*	*(₹ in '000s)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		8,000
(b) Reserves and Surplus	1	3,096
(2) Minority Interest (W.N.7)		952
(3) Current Liabilities	2	4,200
Total		16,248
II. Assets		
(1) Non-current assets		
Fixed assets		
Intangible assets	3	688
(2) Current assets	4	15,560
Total		16,248

Notes to Accounts

			₹ in '000s
1.	Reserves and Surplus		
	General Reserve	1,600	

	Profit & Loss (W.N.6)	1,496	3,096
2.	Current Liabilities		
	Ram Ltd.	1,280	
	Shyam Ltd.	3,000	
	Tom Ltd.	1,120	
		5,400	
	Less: Mutual Owings	(1,200)	4,200
3.	Intangible assets		
	Goodwill (W. N. 5)		688
4.	Current Assets		
	Ram Ltd.	7,240	
	Shyam Ltd.	7,520	
	Tom Ltd.	2,080	
		16,840	
	Less: Mutual Owings	(1,200)	
		15,640	
	Less: Unrealised Profit	(80)	15,560

Working Notes:

Shareholding Pattern

	Shyam Ltd.	Tom Ltd.
Total Shares	40,000 shares	16,000 shares
Held by Ram Ltd.	32,000 shares (80%)	4,000 shares (25%)
Held by Shyam Ltd.	NA	12,000 shares (75%)
Minority Interest	8,000 shares (20%)	NIL

1. General Reserve and Profit and Loss Account of Shyam Ltd.

General Reserve Account of Shyam Ltd.

		₹'000			₹'000
31.3.15	To Balance c/d	280	1.4.14	By Balance b/d	280

Draft Profit and Loss Account of Shyam Ltd.

		₹ '000			₹ '000
31.3.15	To Balance c/d	960	1.4.14	By Balance b/d	520
				By Profit earned during the year (Bal. Fig.)	440
		960			960

2. **Draft Profit and Loss Account of Tom Ltd.**

		₹ '000			₹ '000
1.4.12	To Balance b/d	160	31.3.13	By Balance c/d	160
		160			160
1.4.13	To Balance b/d	160	31.3.14	By Balance c/d	480
	To Loss incurred during the year (Bal. Fig.)	320			
		480			480
1.4.14	To Balance b/d	480	31.3.15	By Balance c/d	640
	To Loss incurred during the year (Bal. Fig.)	160			
		640			640

3. **Analysis of Profits of Tom Ltd.**

		Capital Profits ₹ '000	Revenue Profits ₹ '000
(i)	**From the viewpoint of Shyam Ltd.**		
	Debit Balance in Profit and Loss Account as on 1.4.2014	(160)	
	Loss incurred between 1.4.2014 to 31.3.2017 [(320 + 160)– Refer W.N. 2]		(480)
		(160)	(480)
	Share of Shyam Ltd.-75% [carried forward to W. N. 4]	(120)	(360)
(ii)	**From the view point of Ram Ltd.**		
	Debit Balance of Profit and Loss Account as on 1.4.14	(480)	
	Loss during the year 2016-2017 [WN 2]		(160)
		(480)	(160)
	Share of Ram Ltd. (25%)	(120)	(40)

4. **Analysis of Profits of Shyam Ltd. (From the viewpoint of Ram Ltd.)**

	Capital Profits ₹ '000	Revenue Profits ₹ '000
General Reserve as on 1.4.2016	280	
Profit and Loss Account Balance as on 1.4.2016	520	

Profit earned during 2016-2017 (W.N.1)		440
Brought forward Shyam Ltd.'s share of loss in Tom Ltd. [W. N. 3(i)]	(120)	(360)
Share of Shyam Ltd. in revenue loss of Tom Ltd. for the period 1.4.12 to 31.3.14 [75% of (360- 40)] being treated as capital loss from view point of Ram Ltd.	(240)	240
	440	320
Less: Share of Minority Interest (20%)	(88)	(64)
Balance taken to Ram Ltd. (80%)	352	256

5. **Cost of Control**

		₹ '000
Investment by Ram Ltd. in		.
Shyam Ltd.	4,800	
Tom Ltd.	200	
Investment by Shyam Ltd. in		
Tom Ltd.	720	5,720
Less: Paid up value of shares of:		
Shyam Ltd.	3,200	
Tom Ltd. (400 + 1,200)	1,600	
	4,800	
Capital loss of Ram Ltd. in Tom Ltd. [W.N. 3(ii)]	(120)	
Capital Profit of Ram Ltd. in Shyam Ltd. (W.N. 4)	352	(5,032)
Goodwill		688

6. **Consolidated Profit and Loss A/c of Ram Ltd.**

		₹ '000
Profit and Loss A/c Balance		1,360
Post-acquisition share of loss from Tom Ltd.		(40)
Post-acquisition share of profit from Shyam Ltd.		256
		1,576
Less: Unrealised Profit on Inventory ($\frac{1}{6}$ th of 480)		(80)
		1,496

7. Minority Interest

	₹'000
Paid up value of shares in Shyam Ltd. (20% of 4,000)	800
Share of Capital Profit (W.N.4)	88
Share of Revenue Profit (W.N.4)	64
	952

Question 17

The summarized Balance Sheets of three companies Sun Ltd., Moon Ltd. and Light Ltd. as at 31st March, 2017 are given below:

Liabilities	*Sun Ltd.* ₹	*Moon Ltd.* ₹	*Light Ltd.* ₹	*Assets*	*Sun Ltd.* ₹	*Moon Ltd.* ₹	*Light Ltd.* ₹
Share Capital				*Fixed Assets*	*70,000*	*1,20,000*	*1,03,000*
(Shares of ₹ 10 each)	*1,50,000*	*1,00,000*	*60,000*	*Investments (at cost)*			
Reserves	*50,000*	*40,000*	*30,000*	*Shares in:*			
Profit and	*60,000*	*50,000*	*40,000*	*Moon Ltd.*	*90,000*	*-*	*-*
Loss A/c							
	30,000	*35,000*	*25,000*	*Light Ltd.*	*40,000*	*-*	*-*
Trade payables							
				Light Ltd.	*-*	*50,000*	*-*
Sun Ltd.	*-*	*10,000*	*8,000*	*Inventory-in-trade*	*40,000*	*30,000*	*20,000*
				Trade receivables	*20,000*	*25,000*	*30,000*
				Due from--			
				Moon Ltd.	*12,000*		
				Light Ltd.	*8,000*		
				Cash in hand	*10,000*	*10,000*	*10,000*
	2,90,000	*2,35,000*	*1,63,000*		*2,90,000*	*2,35,000*	*1,63,000*

(a) Sun Ltd. held 8,000 shares of Moon Ltd. and 1,800 shares of Light Ltd.

(b) Moon Ltd. held 3,600 shares of Light Ltd.

(c) All investments were made on 1st July, 2016.

(d) The following balances were there on 1st July, 2016:

	Moon Ltd. ₹	Light Ltd. ₹
Reserves	*25,000*	*15,000*
Profits and Loss A/c	*20,000*	*25,000*

(e) Moon Ltd. invoiced goods to Sun Ltd. for ₹ 4,000 at a cost plus 25% in December, 2016. The closing inventory of Sun Ltd. includes such goods valued at ₹ 5,000.

(f) Light Ltd. sold to Moon Ltd. an equipment costing ₹ 24,000 at a profit of 25% on selling price on 1st January, 2017. Depreciation at 10% per annum was provided by Moon Ltd. on the equipment.

(g) Sun Ltd. declared dividend at 10%.

Prepare the Consolidated Balance Sheet of the group as at 31st March, 2017. Working should form part of the answer.

Answer

Consolidated Balance Sheet of Sun Ltd. and its subsidiaries Moon Ltd. and Light Ltd. as at 31st March, 2017

Particulars	Note No.	(₹)
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	1,50,000
(b) Reserves and Surplus	2	1,73,516
(2) Minority Interest		52,684
(3) Current Liabilities		
(a) Trade Payables	3	90,000
(b) Other current liabilities	4	15,000
Total		4,81,200
II. Assets		
(1) Non-current assets		
Fixed assets	5	2,85,200
(2) Current assets		
(a) Inventories	6	89,000
(b) Trade receivables	7	75,000
(c) Cash and cash equivalents	8	32,000
Total		4,81,200

Notes to Accounts

			₹
1.	Reserves and Surplus		
	Capital Reserve (W.N.3)	26,000	
	Other Reserves (W.N.7)	73,700	
	Profit and Loss Account (W. N. 6)	73,816	1,73,516
2.	Minority interest		
	Moon Ltd. (W. N. 4)	40,464	
	Light Ltd. (W.N.4)	12,220	52,684
3.	Trade Payables		
	Sun Ltd.	30,000	
	Moon Ltd.	35,000	
	Light Ltd.	25,000	90,000
4.	Other current liabilities		
	Dividend		15,000
5.	Fixed Assets		
	Sun Ltd.	70,000	
	Moon Ltd. ₹ 1,20,000		
	Less: Unrealised Profit (W.N.5) ₹ (7,800)	1,12,200	
	Light Ltd.	1,03,000	2,85,200
6.	Inventories		
	Sun Ltd. ₹ 40,000		
	Less: Unrealised Profit ₹ (1,000)	39,000	
	Moon Ltd.	30,000	
	Light Ltd.	20,000	89,000
7.	Trade Receivables		
	Sun Ltd.	20,000	
	Moon Ltd.	25,000	
	Light Ltd.	30,000	75,000
8.	Cash and cash equivalents		
	Cash in hand		
	Sun Ltd. ₹ 10,000		

	Moon Ltd. ₹ 10,000		
	Light Ltd. ₹ 10,000	30,000	
	Cash in transit (W.N.8)	2,000	32,000

Working Notes:

1. **Analysis of Profits of Light Ltd.**

	Pre-acquisition	*Post-acquisition*	
	Capital Profit	*Revenue Reserves*	*Revenue Profits*
	₹	₹	₹
Reserves on 1.7.2016	15,000	-	-
Profit and Loss A/c on 1.7.2016	25,000	-	-
Increase in Reserves	-	15,000	-
Increase in Profit	-	-	15,000
	40,000	15,000	15,000
Less: Minority Interest (10%)	(4,000)	(1,500)	(1,500)
	36,000	13,500	13,500
Share of Sun Ltd.	12,000	4,500	4,500
Share of Moon Ltd.	24,000	9,000	9,000

2. **Analysis of Profits of Moon Ltd.***

	Pre-acquisition	*Post-acquisition*	
	Capital Profit	*Revenue Reserves*	*Revenue Profits*
	₹	₹	₹
Reserves on 1.7.2016	25,000	-	-
Profit and Loss A/c on 1.7.2016	20,000	-	-
Increase in Reserves	-	15,000	-
Increase in Profit	-	-	30,000
	45,000	15,000	30,000
Add: Share in Light Ltd. (post acquisition)	-	9,000	9,000

* Treatment of capital profit of sub-subsidiary company i.e. Light Ltd. has been done by applying direct approach.

Less: Unrealised profit on equipment (60% of 7,800)			(4,680)
	45,000	24,000	34,320
Less: Minority Interest (20%)	(9,000)	(4,800)	(6,864)
Share of Sun Ltd.	36,000	19,200	27,456

3. Cost of Control

				₹
Investment in Moon Ltd.				90,000
Investment in Light Ltd.				
		₹		
	by Moon Ltd.	50,000		
	by Sun Ltd.	40,000		90,000
				1,80,000
Less: Paid up value of shares				
	in Moon Ltd.	80,000		
	in Light Ltd.	54,000	1,34,000	
Capital Profit of Sun Ltd.				
	in Moon Ltd.	36,000		
	in Light Ltd.	12,000	48,000	
Capital profit of Moon Ltd. in Light Ltd.			24,000	(2,06,000)
Capital Reserve				26,000

4. Minority Interest

	Moon Ltd.	Light Ltd.
	₹	₹
Share Capital	20,000	6,000
Capital Profit	9,000	4,000
Revenue Reserves	4,800	1,500
Revenue Profits	6,864	1,500
	40,664	13,000
Less: Unrealised Profit on Inventory 20% of (₹ 5,000 x 25/125)	(200)	
Unrealised Profit on Equipment (10% of ₹ 7,800)		(780)
	40,464	12,220

5. Unrealised Profit on Equipment Sale

	₹
Selling price of the equipment $\left(24{,}000 \text{x} \frac{100}{75}\right)$	32,000
Less: Cost price of the equipment	(24,000)
Profit on sale	8,000
Unrealised profit = [8,000-(8,000 x $\frac{10}{100}$ x $\frac{3}{12}$)] = ₹ 7,800	

6. Profit and Loss Account – Sun Ltd.

	₹
Balance as per separate Balance Sheet	60,000
Less: Dividend	(15,000)
	45,000
Add: Share in Moon Ltd.	27,456
Share in Light Ltd.	4,500
	76,956
Less: Unrealised profit on Equipment (30% of 7,800)	(2,340)
	74,616
Less: Unrealised profit on Inventory (5,000x $\frac{25}{125}$ x80%)	(800)
	73,816

7. Other Reserves – Sun Ltd.

	₹
Balance as per separate Balance Sheet	50,000
Share in Moon Ltd.	19,200
Share in Light Ltd.	4,500
	73,700

8. Cash in Transit

	₹
Due to Sun Ltd. from Moon Ltd.	12,000
Less: Due by Moon Ltd.	(10,000)
	2,000

Question 18

Kim and Kin floated a new company KimKin Ltd. on 1st April 2016 with a capital of ₹ 5 lakhs represented by 50,000 ordinary shares of ₹ 10 each, subscribed equally by both groups.

Kimkin Ltd. made the following acquisitions on the same date:

(1) 3,000 shares of ₹ 10 each in Klean Ltd. at ₹ 35,000

(2) 10,000 shares of ₹ 10 each in Klinic Ltd. for ₹ 72,000

(3) 8,000 equity shares of ₹ 10 each in Klear Ltd. for ₹ 92,000 and 200 8% Cumulative Preference shares @ ₹ 140 per share.

The following are the summarized Balance sheets of the three companies as on 31.03.2017

Liabilities

	Klean Ltd. (₹)	Klinic Ltd. (₹)	Klear Ltd. (₹)
Equity Share Capital	40,000	1,20,000	1,00,000
8% Cumulative Preference shares Capital (₹ 100 shares)			25,000
Reserves (31.03.2016)	3,000		7,500
Profit & Loss Account	6,000		15,000
Trade payables	2,900	8,000	7,500
Total	51,900	1,28,000	1,55,000

Assets

	(₹)	(₹)	(₹)
Goodwill (purchased)	4,000		15,000
Freehold Land	8,000	52,000	50,000
Plant & machinery	16,000	19,000	37,000
Inventories	8,900	25,000	26,000
Trade receivables	4,000	12,000	15,500
Bank	11,000	2,000	11,500
Profit & Loss A/c	………	18,000	………
Total	51,900	1,28,000	1,55,000

You are supplied with the following information and requested to compile the Consolidated Balance Sheet as on 31st March 2017 of the entire Group.

1. The freehold land of Klear Ltd. carries a fair value of ₹ 65,000 as on 1-04-2016.
2. The plant & machinery of Klinic Ltd. to be depreciated by ₹ 3,000.

3. *Inventories of Klean Ltd. are undervalued by ₹ 2,000.*
4. *On Balance Sheet date, Kimkin Ltd. owed Klean Ltd. ₹ 10,500 and is owed ₹ 8,200 by Klinic Ltd. Klear Ltd. is owed ₹ 1,300 by Klean Ltd. and ₹ 2,000 by Klinic Ltd.*
5. *The balances in Profit and Loss account on date of acquisition were : Klean Ltd. ₹ 2,000 (Cr); Klinic Ltd. ₹ 12,000 (Dr.) and Klear Ltd. ₹ 4,000 (Cr.)*

   The credit balances of Klean Ltd. & Klear. Ltd. were wholly distributed as dividends in June 2016.
6. *During 2016-2017 Klean Ltd. & Klear Ltd. declared and paid interim dividends of 8% and 10% respectively.*
7. *Klear Ltd. has discharged dividend obligations towards its preference shareholders up-to March 2015.*

Answer

Note: It is assumed that the preference shares given in the question are non-convertible in the nature.

Consolidated Balance Sheet of Kimkin Ltd. & its subsidiaries as on 31-03-2017

Particulars	*Note No.*	*(₹)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	5,00,000
(b) Reserves and Surplus	2	37,250
(2) Minority Interest		61,750
(3) Current Liabilities		
(a) Trade Payables		19,600
(b) Short term provision (preference dividend)		1,600
Total		6,20,200
II. Assets		
(1) Non-current assets		
Fixed assets		
(a) Tangibles assets	3	1,94,000
(b) Intangible assets	4	19,000
(2) Current assets		
(a) Inventories (W.N 5)		61,900

(b) Trade receivables		28,200
(c) Cash and cash equivalents	5	3,17,100
Total		6,20,200

Notes to Accounts

			₹
1.	Share Capital		
	Authorised, Issued, Subscribed & Paid up 50,000 Ordinary shares of ₹ 10 each		5,00,000
2.	Reserves and Surplus		
	Capital Reserve	17,950	
	Profit & Loss Account (W.N. 6)	19,300	37,250
3.	Tangible Assets		
	Freehold lands (W.N. 5)	1,25,000	
	Plant & Machinery (W.N 5)	69,000	1,94,000
4.	Intangible assets		
	Goodwill (4,000+15,000)		19,000
5.	Cash and cash equivalents		
	Bank Balances (W.N. 5)	3,14,900	
	Cash in transit (W.N 7)	2,200	3,17,100

Working Notes:

1.	Analysis of profits	₹	₹
	Klean Ltd.	Capital	Revenue
	Reserves as on 1st April, 2016	3,000	
	Profit and Loss account as on 1st April, 2016 net of dividend	0	
	Current year profits after interim dividend of ₹ 3,200		6,000
	Appreciation in inventory value		2,000
		3,000	8,000
	Less: Minority interest (1/4)	(750)	(2,000)
	Share of Kimkin Ltd. (3/4)	2,250	6,000
	Klinic Ltd.	Capital	Revenue
	Loss on date of acquisition	(12,000)	

	Current year loss after additional depreciation of ₹ 3,000 = (18,000 + 3,000 - 12,000)		(9,000)
		(12,000)	(9,000)
	Less: Minority interest (1/6)	(2,000)	(1,500)
	Share of Kimkin Ltd. (5/6)	(10,000)	(7,500)
	Klear Ltd.	Capital	Revenue
		₹	₹
	Reserves as on 1st April, 2016	7,500	
	Profit & Loss as on 1st April, 2016 net of dividend	0	
	Current year profits after interim dividend of ₹ 10,000		15,000
	Appreciation in freehold property value as on 01.04.2016	15,000	
	Arrears of Preference Dividend of Minority's Preference Shares (as per para 27 of AS 21)	(2,000)	(2,000)
		20,500	13,000
	Less: Minority Interest (1/5)	(4,100)	(2,600)
	Share of Kimkin Ltd. (4/5)	16,400	10,400
2.	Cost of control/capital reserve		₹
	Cost of Investment in Klean Ltd.	35,000	
	Less: Pre-acquisition Dividend = ¾ x 2,000	(1,500)	33,500
	Cost of Investment in Klinic Ltd.		72,000
	Cost of Equity Investment in Klear Ltd.	92,000	
	Less: Pre-acquisition Dividend = 4/5 x 4,000	(3,200)	88,800
	Cost of Investment in Cum-Preference shares in Klear Ltd.	28,000	
	Less: Pre-acquisition preference dividend = 4/5 x 2,000	(1,600)	26,400
			2,20,700
	Less: Paid up Value of Equity Shares in Klean Ltd.	30,000	
	Paid up Value of Equity Shares in Klinic Ltd.	1,00,000	
	Paid up Value of Equity Shares in Klear Ltd.	80,000	
	Paid up Value of Preference Shares in Klear Ltd	20,000	(2,30,000)
			(9,300)
	Less: Capital Profits in Klean Ltd	2,250	
	Capital Profits in Klinic Ltd.	(10,000)	
	Capital Profits in Klear Ltd	16,400	(8,650)
	Capital Reserve		17,950

3. Minority Interest

	Klean Ltd (₹)	*Klinic Ltd. (₹)*	*Klear Ltd. (₹)*
Equity Share Capital	10,000	20,000	20,000
Preference Share Capital			5,000
Arrears of Preference Dividend			800
Capital Profits	750	(2,000)	4,100
Revenue Profits	2,000	(1,500)	2,600
	12,750	16,500	32,500

4. Bank Account of Kimkin Ltd.

	₹		₹
To Share Capital	5,00,000	By investments in Klean Ltd.	35,000
To Investment in Klean Ltd. (Pre-acquisition Dividend)	1,500	By Investments in Klinic Ltd.	72,000
To Investment in Klear Ltd. (Pre-acquisition Dividend)	3,200	By Investments in Klear Ltd. (92,000 + 28,000)	1,20,000
To Dividend Received		By Klinic Ltd (Owings)	8,200
Klean Ltd.	2,400	By Balance c/d	2,90,400
Klear Ltd.	8,000		
To Klean Ltd. (Owings)	10,500		
	5,25,600		5,25,600

5. Statement showing consolidated balances

	Land	*Plant*	*Inventory*	*Trade receivables*	*Bank*	*Trade payables*
	₹	₹	₹	₹	₹	₹
Kimkin Ltd.				8,200	2,90,400	10,500
Klean Ltd.	8,000	16,000	10,900	4,000	11,000	2,900
Klinic Ltd.	52,000	16,000	25,000	12,000	2,000	8,000
Klear Ltd.	65,000	37,000	26,000	15,500	11,500	7,500
	1,25,000	69,000	61,900	39,700	3,14,900	28,900
Less: Mutual Owings				(11,500)*		(9,300)*
Consolidated Balances	1,25,000	69,000	61,900	28,200	3,14,900	19,600

* According to the additional information given in the question, balance of trade receivables A/c of Klean Ltd. should be ₹ 10,500 or more. However, Balance Sheet of Klean Ltd. showed trade receivables of ₹ 4,000 only which is very low in comparison to ₹ 10,500. Therefore, it is presumed that the entry of ₹ 10,500 has been omitted in the books of Klean Ltd. Hence, no elimination of mutual owing in respect of ₹ 10,500 has been made while preparing the consolidated balance sheet.

6. Consolidated Revenue Profits

	₹
Klean Ltd.	6,000
Klinic Ltd.	(7,500)
Klear Ltd.	10,400
	8,900
Add : Interim Dividend received (2,400 + 8,000)	10,400
Consolidated Profit and Loss A/c	19,300

7. Cash-in-Transit

Amount due from Klinic Ltd. (₹ 8,200 ₹ 2,000)	₹ 10,200
Less: Balance of Trade payables of Klinic Ltd.	
as on 31.3.2017 (as per separate balance sheet)	(₹ 8,000)
Cash in transit	₹ 2,200

***Note**:* As per the Companies Act 2013, Preference shareholders have preferential right for the receipt of dividend before equity dividend. However as per the information given in the question, preference dividend is in arrears for last 2 years and equity dividend (interim) is paid during the year 2016-2017. In this regard, it may be noted the workings have been done solely on the basis of the information as given in the question.

Change in Relationship from Subsidiary to Associates

Question 19

Eagle Ltd. had acquired 51% in Sparrow Ltd. for ₹ 75.80 lakhs on April 1st, 2015. On the date of the acquisition Sparrow's Assets stood at ₹ 196 lakhs and liabilities at ₹ 16 lakhs. The Net asset position of Sparrow Ltd. as on 31st March, 2016 & 30th September 2016 were ₹ 280 lakhs & ₹ 395 lakhs respectively, the increase resulting from profits earned during the period.

On 1st October, 2016, 25.5% holdings were sold for ₹ 125 lakhs. You are required to explain the nature of the relationship between the two companies on the relevant dates and the accounting adjustments that are necessary as a result of any change in the relationship. The profit arising on part sale of investment, carrying value of the portion unsold & goodwill/capital reserve that arises on change in nature of the investment may also be worked out by you.

Answer

Sparrow Ltd. became a subsidiary of Eagle Ltd. on 1st April 2015 when 51% thereof was acquired. The holding–subsidiary relationship continued till 30th September 2016 and from 1st October, 2016 the relationship between the two companies will change to Associate. As per para 24 of AS 21, "Consolidated Financial Statements", the carrying value of the investment at the date it ceases to be subsidiary is regarded as cost thereafter. Accordingly, if the nature of the investee changes to that of an associate, the carrying amount of the investment in Consolidated Financial Statements of the investor, as on date it ceases to be a subsidiary, would be considered as cost of investment in the associate. Goodwill or capital reserve arising on account of the change in the nature of the investment will be computed as on the date of such change. Accordingly, when a part of the investment takes the form of an investment in an associate, the results of operations of the subsidiary will be included in the consolidated statement of Profit and Loss for the period from the beginning of the period until it ceased to be a subsidiary.

Ascertainment of Gain or Loss on the Disposal of the Part of the Investment in Sparrow Ltd.

		₹
Proceeds received on sale of 25.5% holdings in Sparrow Ltd.		1,25,00,000
Net Assets of sparrow Ltd. on the date of disposal	3,95,00,000	
Less: Minority's interest in Sparrow Ltd. on the date of disposal	(1,93,55,000)	
Share of Eagle Ltd. in Net Assets	2,01,45,000	
Less: Capital reserve on acquisition (Refer W.N.)	(16,00,000)	
Total value of investment in consolidated financial statements of Eagle Ltd.	1,85,45,000	
Less: Carrying Value of investment disposed off		
(1,85,45,000 x 25.5/51)		92,72,500
Profit on sale of 25.5% of investment		32,27,500

Carrying Value of the Investment retained in the Consolidated Financial Statements		₹
Total value of investment in consolidated financial statements of Eagle Ltd.	1,85,45,000	
Less: Carrying value of investment disposed off	(92,72,500)	
Carrying Value of the investment retained in consolidated financial statements including capital reserve		92,72,500
This amount of ₹ 92,72,500 would be used to apply the equity method of accounting as specified in AS 23		
Goodwill / Capital Reserve arising on the Carrying Value of Unsold Portion of the Investment		₹
Carrying value of 25.5% holdings in Sparrow Ltd. as on 1st October, 2016		92,72,500
Less: Share in value of equity of Sparrow Ltd., as at date of investment		

when subsidiary relationship is transformed to an associate (3,95,00,000 x 25.5%)	(1,00,72,500)
Capital reserve arising on such investment under Equity method as per AS 23	(8,00,000)

Working Note:

Calculation of Goodwill / Capital Reserve on the Date of Acquisition of Shares in Sparrow Ltd.

	₹
Net Assets on Acquisition date (₹ 1,96,00,000 – ₹ 16,00,000)	1,80,00,000
51% thereof	91,80,000
Less: Cost of investment	(75,80,000)
Capital reserve on acquisition	16,00,000

Question 20

The Balance Sheets of A Ltd. and its subsidiaries B Ltd. and C Ltd. as on 31-3-2016 were as follows:

			₹ in lakhs
	A Ltd.	B Ltd.	C Ltd.
Investments:			
1,00,000 shares in B Ltd.	100	----	----
80,000 shares in C Ltd.	200	----	----
Other Current Assets	700	600	500
	1,000	600	500
Share Capital:			
Shares of ₹ 100 each	400	100	100
Reserves and Surplus	400	300	200
Current Liabilities	200	200	200
	1,000	600	500

A Ltd. acquired shares in B Ltd. in April 2013 when B Ltd. was formed with share capital of ₹ 100 lakhs.

A Ltd. acquired shares in C Ltd. in April 2013 when C Ltd. had share capital of ₹ 100 lakhs and reserves and surplus of ₹100 lakhs.

The group amortises goodwill on consolidation on a SLM basis over a period of 5 years. A full year's amortization is provided if the goodwill exists for more than 6 months.

On 1st April, 2016, A Ltd. sold 40,000 shares of C Ltd. for cash consideration of ₹ 150 lakhs. The Balance Sheets of the companies for the year 2016-2017 were as follows:

(1) *Balance Sheet as on 31-3-2017* *₹ in lakhs*

	A Ltd.	*B Ltd.*	*C Ltd.*
Investments at cost:			
1,00,000 shares in B Ltd.	*100*		
40,000 shares in C Ltd.	*100*		
Other Current Assets	*1,000*	*800*	*700*
	1,200	*800*	*700*
Share Capital	*400*	*100*	*100*
Reserves and Surplus	*550*	*420*	*280*
Current Liabilities	*250*	*280*	*320*
	1200	*800*	*700*

(2) *Profit and Loss A/c for the year ended 31-3-2017* *₹ in lakhs*

	A Ltd.	*B Ltd.*	*C Ltd.*
Profit before tax	*150*	*180*	*120*
Extraordinary items	*50*	*-*	*-*
	200	*180*	*120*
Tax	*50*	*60*	*40*
Profit after tax	*150*	*120*	*80*
Reserves & Surplus Beginning	*400*	*300*	*200*
Reserves & Surplus-End	*550*	*420*	*280*

Prepare for A Ltd., group Balance Sheets as on 31-3-2016 and as on 31-3-2017.

Answer

Consolidated Balance Sheet as on 31.3.2016

	₹ in lakhs
Assets:	
Other Current Assets (700+600+500)	1,800
Goodwill (after amortisation) (W.N. 1(c))	16
	1,816
Capital and Liabilities:	
Share capital	400
Minority Interest (W.N. 1(b))	60
Reserves and surplus (W.N. 1(d))	756
Current Liabilities (200+200+200)	600
	1,816

Consolidated Balance Sheet as on 31.3.2017

Particulars	*Note No.*	*(₹ in thousands)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		400
(b) Reserves and Surplus	2	1,026
(4) Current Liabilities (250+280)		530
Total		1,956
II. Assets		
(1) Non-current assets		
Non-current investment	1	156
(2) Current assets		
Other current asset		1,800
Total		1,956

Notes to Accounts

		₹ in thousands	
1.	**Non-current investment**		
	Carrying amount of Investment in Associate – C Ltd. [W.N.2(a)]	128	
	(Identified goodwill included in the above ₹ 8 lakhs) [W.N.2(b)]		
	Add: Increase in reserves and surplus during the year (280-200) x 40%	32	
	Less: Goodwill written off in the fourth year ₹ 8 lakhs x ½	(4)	156
2.	**Consolidated Reserves and Surplus**		
	Balance of reserves and surplus of A Ltd. as on 31.3.2017	550	
	Add: Post-acquisition reserves and surplus of B Ltd. (subsidiary)	420	
	Profit accumulated over the years on investment of A Ltd. (128-100)	28	
	Post-acquisition reserves and surplus of C Ltd. (280-200) x 40%	32	
	Less: Goodwill amortised for the period	(4)	1,026

Working Notes:

1. For Consolidated Balance Sheet as on 31.3.2016

   (a) Analysis of Profits

	B Ltd.		*C Ltd.*	
	Pre-acquisition	*Post Acquisition*	*Pre-acquisition*	*Post Acquisition*
		₹ in lakhs	*₹ in lakhs*	*₹ in lakhs*
Reserves and Surplus		300	100	100
A Ltd.		300	80	80
Minority Interest		-	20	20

(b) Minority Interest

	C Ltd.
	₹ in lakhs
Share Capital (20%)	20
Reserves and Surplus	
Pre-acquisition (W.N. 1(a))	20
Post-acquisition (W.N. 1(a))	20
	60

(c) Cost of Control

	B Ltd.	*C Ltd.*
	₹ in lakhs	*₹ in lakhs*
Investment by A Ltd.	100	200
Less: Share capital (80%)	(100)	(80)
Capital profit (pre-acquisition) (W.N. 1(a))	-	80
Goodwill	-	40
Less: Amortization for 3 years [(40/5) x3]		(24)
Carrying value of goodwill after 3 years		16

(d) Consolidated Reserves and Surplus

	₹ in lakhs
Balance of A Ltd. as on 31.3.2016	400
Post-acquisition reserves and surplus of B Ltd. (W.N. 1(a))	300
Post-acquisition reserves and surplus of C Ltd. (W.N. 1(a))	80
	780
Less: Amortisation of goodwill	(24)
	756

2. **For Consolidated Balance Sheet as on 31.3.2017**

C Ltd. became a subsidiary of A Ltd. on 1st April 2013 when 80% thereof was acquired. The holding –subsidiary relationship continued till 31st March, 2016 and from 1st April, 2016 the relationship between the two companies changed to Associate. As per para 24 of AS 21, "Consolidated Financial Statements", the carrying value of the investment at the date it ceases to be subsidiary is regarded as cost thereafter.

Accordingly, if the nature of the investee changes to that of an associate, the carrying amount of the investment in Consolidated Financial Statements of the investor, as on date it ceases to be a subsidiary, would be considered as cost of investment in the associate. Goodwill or capital reserve arising on account of the change in the nature of the investment will be computed as on the date of such change.

(a) Ascertainment of carrying value of investment in C Ltd. disposed off and retained

	₹ in lakhs
Net Assets of C Ltd. on the date of disposal	300
(Total assets of ₹ 500 lakhs - total liabilities of ₹ 200 lakhs)*	
Less: Minority's interest in C Ltd. on the date of disposal (20%)	(60)
Share of A Ltd. in Net Assets	240
Add: Carrying value of Goodwill (Refer W.N.1(c))	16
Total value of investment in consolidated financial statements of A Ltd.	256
Less: Carrying Value of investment disposed off (₹256 lakhs x 40,000/80,000)	(128)
Carrying Value of investment retained	128

(b) Goodwill arising on the Carrying Value of Unsold Portion of the Investment

	₹ in lakhs
Carrying value of retained 40% holdings in C Ltd. as on 1st April, 2016	128
Less: Share in value of equity of C Ltd., as at date of investment when its subsidiary relationship is transformed to an associate (300 x 40%)	(120)
Goodwill arising on such investment under Equity method as per AS 23	(8)

Note: As sale of part investment took place on 1st April, 2016; therefore, it is not accounted again in the consolidated balance sheet assuming that the profit of A Ltd. includes the profit on sale of such investments.

* Calculation of net assets has been made on the basis of Balance Sheet as on 31.3.2016.

Consolidation of Subsidiary and Associate Companies

Question 21

The draft Balance Sheet of three companies, W, H, and O as at 31.3.2017 is as under:

			₹ in thousands
Assets	*W*	*H*	*O*
Fixed assets	*697*	*648*	*349*
Investments			
1,60,000 shares in H	*562*	---	---
80,000 shares in O	*184*	---	---
Cash at bank	*101*	*95*	*80*
Trade receivables	*386*	*321*	*251*
Inventory	*495*	*389*	*287*
Total	*2,425*	*1,453*	*967*
Liabilities			
Share capital (Nominal value ₹ 1 per share)	*600*	*200*	*200*
Reserves	*1,050*	*850*	*478*
Trade payables	*375*	*253*	*189*
Debentures	*400*	*150*	*100*
Total	*2,425*	*1,453*	*967*

You are given the following information:

(a) *W purchased the shares in H on 13.10.2015 when the balance in reserves was ₹ 500 thousands.*

(b) *The shares in O were purchased on 11.5.2015 when the balance in reserves was ₹ 242 thousands.*

(c) *The following dividend have been declared but not accounted for before the accounting year end.*

W	-	*₹ 65 thousands*
H	-	*₹ 30 thousands*
O	-	*₹ 15 thousands*

(d) *Included in inventory figure of O is inventory valued at ₹ 20 thousands which had been purchased from W at cost plus 25%.*

(e) *Goodwill in respect of the acquisition of H has been fully written off.*

(f) *On 31.3.2017 H made bonus issue of one share for every share held. This had not been accounted in the balance sheet as on 31.3.2017.*

(g) Included in trade payables of W is ₹ 18 thousands to O, which is included in trade receivables of O.

Prepare Consolidated Balance Sheet of W as at 31.3.2017.

Answer

Consolidated Balance Sheet of W and its subsidiary H as at 31st March, 2017

Particulars	*Note No.*	*(₹ in thousands)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		600.00
(b) Reserves and Surplus (W.N.4)		1,355.80
(2) Minority Interest (W.N.3)		204.00
(3) Non-Current Liabilities		
Long-term borrowings	1	550.00
(4) Current Liabilities		
(a) Trade Payables (₹ 375+₹ 253)		628.00
(b) Other Current Liabilities	2	71.00
Total		3,408.80
II. Assets		
(1) Non-current assets		
(a) Fixed assets (₹ 697+ ₹ 648)		1,345.00
(b) Non-current investment	3	270.80
(2) Current assets		
(a) Inventories (₹ 495 + ₹ 389)		884.00
(b) Trade receivables (₹ 386 + ₹ 321)		707.00
(c) Cash and cash equivalents	4	196.00
(d) Other current asset	5	6.00
Total		3,408.80

Notes to Accounts

		₹ in thousands	
1.	Long Term Borrowings		
	Debentures (₹400 + ₹ 150)		550.00

2.	Other current liabilities		
	Dividend (W.N.6)		71.00
3.	Non-current investment		
	Investment in Associate (W.N.5)	184.00	
	(including goodwill ₹7.20 thousand)		
	Add: Accumulated reserves	86.80	270.80
4.	Cash and cash equivalents		
	Cash at Bank (₹101+ ₹95)		196.00
5.	Other current asset		
	Dividend receivable from O		6.00

Working Notes:

Shareholding Pattern

Total Shares of H Ltd.	2,00,000 Held by W Ltd.	1,60,000 i.e. 80%
Minority Interest	40,000 [20%]	

1. Analysis of profits of H

		₹ in thousands
	Pre acquisition profits	*Post acquisition profits*
Reserves on the date of acquisition	500	350
Less: Bonus issue*	(200)	-
	300	350
Less: Dividend declared on 31.3.2017	-	(30)
	300	320
Minority interest (20%)	60	64
W's share (80%)	240	256

2. Cost of control/Goodwill

		₹ in thousands
Amount paid for investment		562
Less: Paid up value of shares including bonus (80% of 400)	320	
Share in pre-acquisition profits of H [WN 1]	240	(560)
Goodwill		2

* It is assumed that bonus issue had been made out of pre-acquisition reserves.

3. Minority Interest

	₹ in thousands
Paid up value of share including bonus issue (400 × 20%)	80
Share in pre acquisition profits of H [WN 1]	60
Share in post acquisition profits of H [WN 1]	64
	204

4. Consolidated Reserves

		₹ in thousands
Balance as per W's Balance Sheet		1,050.00
Add: Share in post-acquisition profits of H [WN 1]		256.00
Dividend from H		24.00
Share of profit from Associate O	86.80	
Add: Dividend from O	6.00	92.80
		1,422.80
Less: Dividend payable	65.00	
Goodwill written off	2.00	(67.00)
		1,355.80

5. Investment in Associate O as on 31.03.2017 (As per AS 23)

		₹ in thousands
Amount paid for investment		184.00
Less: Paid up value of shares	80.00	
Share in pre acquisition reserves (40% of ₹ 242)	96.8	(176.80)
Goodwill (Identified at the time of purchase)		7.20
Initial cost		184.00
Add: Increase in equity reserves [40% of ₹ (478 –15 –242)]	88.40	
Less: Unrealised profit $\left(20\times\frac{25}{125}\right)\times 40\%$	(1.60)	86.80
Investment in Associate O as on 31.03.2017		270.80
Share of profit from Associate O ₹ (270.80 – 184 + 6)		92.80

6. Dividend

	₹ in thousands
W	65
Minority Interest (₹ 30 – ₹ 24)	6
	71

Financial Reporting of Interest in Jointly Controlled Entities

Question 22

Air Ltd., a listed company, entered into an expansion programme on 1st April, 2016. On that date the company purchased from Bag Ltd. its investments in two Private Limited Companies. The purchase was of

(a) the entire share capital of Cold Ltd.

and

(b) 50% of the share capital of Dry Ltd.

Both the investments were previously owned by Bag Ltd. After acquisition by Air Limited, Dry Ltd. was to be run by Air Ltd. and Bag Ltd. as a jointly controlled entity.

Air Ltd. makes its financial statements upto 31st March each year. The terms of acquisition were:

Cold Ltd.

The total consideration was based on price earnings ratio (P/E) of 12 applied to the reported profit of ₹ 20 lakhs of Cold Ltd. for the year 31st March, 2016. The consideration was settled by Air Ltd. issuing 8% debentures for ₹ 140 lakhs (at par) and the balance by a new issue of ₹ 1 equity shares, based on its market value of ₹ 2.50 each.

Dry Ltd.

The market value of Dry Ltd. on 1st April, 2016 was mutually agreed as ₹ 375 lakhs. Air Ltd. satisfied its share of 50% of this amount by issuing 75 lakhs ₹ 1 equity shares (market value ₹ 2.50 Each) to Bag Ltd.

Air Ltd. has not recorded in its books the acquisition of the above investments or the discharge of the consideration.

The summarized statements of financial position of the three entities at 31st March, 2017 are:

			₹ in thousands
	Air Ltd.	Cold Ltd.	Dry Ltd.
Assets			
Tangible Assets	34,260	27,000	21,060
Inventories	9,640	7,200	18,640
Trade receivables	11,200	5,060	4,620
Cash	-	3,410	40
	55,100	42,670	44,360
Liabilities			
Equity capital:			
₹ 1 Each	10,000	20,000	25,000

Retained earnings	*20,800*	*15,000*	*4,500*
Trade and other payables	*17,120*	*5,270*	*14,100*
Overdraft	*1,540*	*-*	*-*
Provision for taxes	*5,640*	*2,400*	*760*
	55,100	*42,670*	*44,360*

The following information is relevant.

(a) The book values of the net assets of Cold Ltd. and Dry Ltd. on the date of acquisition were considered to be a reasonable approximation to their fair values.

(b) The current profits of Cold Ltd. and Dry Ltd. for the year ended 31st March, 2017 were ₹ 80 lakhs and ₹ 20 lakhs respectively. No dividends were paid by any of the companies during the year.

(c) Dry Ltd., the jointly controlled entity, is to be accounted for using proportional consolidation, in accordance with AS 27 "Interests in joint venture".

(d) Goodwill in respect of the acquisition of Dry Ltd. has been impaired by ₹ 10 lakhs at 31st March, 2017. Gain on acquisition, if any, will be separately accounted.

Prepare the consolidated Balance Sheet of Air Ltd. and its subsidiaries as at 31st March, 2017.

Answer

Consolidated Balance Sheet of Air Ltd.
with its Subsidiary Cold Ltd. and Jointly controlled Dry Ltd.
as on 31st March, 2017

Particulars	*Note No.*	*(₹ in thousands)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital	1	21,500
(b) Reserves and Surplus	2	49,050
(2) Non-Current Liabilities		
Long-term borrowings	3	15,540
(3) Current Liabilities		
(a) Trade Payables ₹ (17,120 + 5,270 + 7,050)		29,440
(b) Short-term provisions	4	8,420
Total		1,23,950
II. Assets		
(1) Non-current assets		
Fixed assets		
(a) Tangibles assets ₹ (34,260+27,000+10,530)		71,790

	(b) Intangible assets (W.N.6)		4,000
(2)	**Current assets**		
	(a) Inventories ₹ (9,640 + 7,200 + 9,320)		26,160
	(b) Trade receivables ₹ (11,200+5,060+2,310)		18,570
	(c) Cash and cash equivalents	5	3,430
	Total		1,23,950

Notes to Accounts

			₹ in thousands
1.	Share Capital		
	Equity Capital ₹ (10,000 + 4,000 + 7,500)		
	(Out of the above 11,500 thousand shares have been issued for consideration other than cash)		21,500
2.	Reserves and Surplus		
	Retained Earnings (W.N.4)	28,800	
	Capital Reserve (W.N.5)	3,000	
	Securities Premium	17,250	49,050
3.	Long Term Borrowings		
	8% Debentures	14,000	
	Overdraft	1,540	15,540
4.	Short-term provisions		
	Provision for taxes ₹ (5,640 + 2,400 + 380)		8,420
5.	Cash and cash equivalents		
	Cash ₹ (3,410 + 20)		3,430

Working Notes:

1. **Purchase consideration paid to Cold Ltd.**

Earnings per share for the year 31st March, 2016

$$= \frac{20,00,000}{2,00,00,000} = ₹\ 0.10 \text{ per share}$$

Market price per share = ₹ 0.10 x 12 (i.e. P/E ratio) = ₹ 1.20 per share
Purchase consideration = ₹ 1.20 x 2,00,00,000 shares= ₹ 2,40,00,000

Purchase consideration to be paid as under:

8% Debentures	₹ 1,40,00,000
Equity Shares (40,00,000 shares of ₹ 2.50 each)	₹ 1,00,00,000
	₹ 2,40,00,000

Purchase consideration paid to Cold Ltd. will be ₹ 24,000 thousands.

2. Consideration paid to Dry Ltd.

	(₹ in thousands)
Total market value (as given)	37,500
50% Shares acquired by Air Ltd.(75,00,000 shares @ ₹ 2.50 each)	18,750

3. Analysis of retained earnings of Cold Ltd. as on 31st March, 2017

	(₹ in thousands)
Retained earnings given in balance sheet on 31.3.2017	15,000
Less: Current profits for the year ended 31.3.2017 (Post acquisition)	(8,000)
Pre acquisition retained earnings	7,000

Air Ltd. has 100% share in pre and post acquisition profits of Cold Ltd.

4. Retained Earnings in the Consolidated Balance Sheet

	₹ in thousands
Balance in Air Ltd. balance sheet	20,800
Add: Share in post acquisition profits of Cold Ltd.	8,000
Add: Share in post acquisition profits of Dry Ltd. (joint venture)	1,000
	29,800
Less: Goodwill (written off)	(1,000)
	28,800

5. Capital Reserve

		₹ in thousands
Amount Paid		24,000
Less: Paid up value of shares	20,000	
Pre-acquisition profit	7,000	(27,000)
Capital Reserve		3,000

6. Goodwill

	₹ in thousands
Amount paid for shares of Dry Ltd (₹ 37,500 x 50%)	18,750

Less: Paid up value of shares (₹ 25,000x 50%)	(12,500)
Pre-acquisition profit (₹ 2,500 x 50%)	(1,250)
Goodwill	5,000
Less: Impairment (Written off)	(1,000)
	4,000

Consolidation of Financial Statements of Subsidiary, Associate and Joint Venture

Question 23

P Ltd. owns 80% of S and 40% of J and 40% of A. J is jointly controlled entity and A is an associate. Summarised Balance Sheets of four companies as on 31.03.15 are:

				(₹ in lakhs)
	P Ltd.	S	J	A
Investment in S	800	-	-	-
Investment in J	600	-	-	-
Investment in A	600	-	-	-
Fixed assets	1000	800	1400	1000
Current assets	2200	3300	3250	3650
Total	5200	4100	4650	4650
Liabilities:				
Share capital ₹ 1				
Equity share	1000	400	800	800
Retained earnings	4000	3400	3600	3600
Trade payables	200	300	250	250
Total	5200	4100	4650	4650

P Ltd. acquired shares in 'S' many years ago when 'S' retained earnings were ₹ 520 lakhs. P Ltd. acquired its shares in 'J' at the beginning of the year when 'J' retained earnings were

₹ 400 lakhs. P Ltd. acquired its shares in 'A' on 01.04.14 when 'A' retained earnings were ₹ 400 lakhs.

The balance of goodwill relating to S had been written off three years ago. The value of goodwill in 'J' remains unchanged.

Prepare the Consolidated Balance Sheet of P Ltd. as on 31.03.15 as per AS 21, 23, and 27.

Answer

Consolidated Balance Sheet of P Ltd. as on 31.3.15

Particulars	*Note No.*	*(₹ in lacs)*
I. Equity and Liabilities		
(1) Shareholder's Funds		
(a) Share Capital		1,000
(b) Reserves and Surplus	1	8,800
(2) Minority Interest (W.N.3)		760
(3) Current Liabilities		
Trade Payables (200+ 300 + 40% of 250)		600
Total		11,160
II. Assets		
(1) Non-current assets		
(a) Fixed assets		
Tangible assets [1,000 + 800 + 560 (1400 x 40%)]		2,360
Intangible assets (W.N.1)		120
(b) Non-current investment	2	1,880
(2) Current assets [2,200 + 3,300 + 1,300 (3,250 x 40%)]		6,800
Total		11,160

Notes to Accounts

			₹ in lacs
1.	Reserves and Surplus		
	Retained Earnings(W.N.2)		8,800
2.	Non-current investment		
	Investment in Associates (W.N.4)		1,880

Working Notes:

1. **Computation of Goodwill**

S (subsidiary)

		₹ in lacs
Cost of investment		800
Less: Paid up value of shares acquired	320	

Share in pre- acquisition profits of S Ltd. (520 × 80%)	416	(736)
Goodwill		64

J (Jointly Controlled Entity)

		₹ in lacs
Cost of Investment		600
Less: Paid up value of shares acquired (40% of 800)	320	
Share in pre-acquisition profits (40% of 400)	160	(480)
Goodwill		120

Note: Jointly controlled entity 'J' to be consolidated on proportionate basis i.e. 40% as per AS 27

Associate A (AS 23)

	₹ in lacs
Cost of investment	600
Less:Paid up value of shares acquired (800 x 40%) ₹ 320	
Share in pre-acquisition profits (400 x 40%) ₹ 160	(480)
Goodwill	120

Goodwill shown in the Consolidated Balance Sheet

	₹ in lacs
Goodwill of 'J'	120
Goodwill of 'S'	64
Less:Goodwill written off of 'S'	(64)
Goodwill	120

2. Consolidated Retained Earnings

	₹ in lacs
P Ltd.	4,000
Share in post acquisition profits of S - 80% (3,400 – 520)	2,304
Share in post acquisition profits of J - 40% (3,600 – 400)	1,280
Share in post acquisition profits of A - 40% (3,600 – 400)	1,280
Less: Goodwill written off	(64)
	8,800

3. Minority Interest 'S'

	₹ in lacs
Share Capital (20% of 400)	80
Share in Retained Earnings (20% of 3,400)	680
	760

4. Investment in Associates

	₹ in lacs
Cost of Investments (including goodwill ₹ 120 lakhs)	600
Share of post acquisition profits	1,280
Carrying amount of Investment (including goodwill ₹ 120 lakhs)	1,880

Exercise

Question 1

Following are the draft Balance Sheets of two companies A Ltd. and B Ltd. as at 31.03.2017:

				(₹ in lakhs)	
Liabilities	*A Ltd.*	*B Ltd.*	*Assets*	*A Ltd.*	*B Ltd.*
Share Capital			*Fixed Assets*	*5.00*	*1.50*
(₹ 100 each)	*6.00*	*3.00*	*Investment:*		
Profits:			*2,400 Shares in B Ltd.*	*3.00*	–
Capital Profit	*0.80*	*0.85*	*1,200 Shares in A Ltd.*	–	*2.00*
Reserve Profit	*3.20*	*0.29*	*Current Assets:*		
Trade payables	*1.50*	*0.81*	*Trade receivables*	*2.00*	*0.80*
			Inventory	*0.40*	*0.30*
			Cash and Bank	*1.10*	*0.35*
	11.50	*4.95*		*11.50*	*4.95*

The following adjustments were not yet made:

1. *Inventory worth ₹ 5,000 in B Ltd. was found to be obsolete with no value.*
2. *A Ltd. acquires an asset costing ₹ 50,000 on 31.3.2017. No effect has been given for both the purchase and payment.*
3. *During the year A Ltd. sold an asset for ₹ 60,000 (original cost ₹ 40,000). The profit was included in the revenue profit.*
4. *Trade receivables of A Ltd. included a sum of ₹ 50,000 owed by B Ltd.*

You are required to prepare the consolidated Balance Sheet of both the companies as on 31.3.2017 after giving effect to the above adjustments.

[Answer: CBS Total ₹1,130 (in'000s); Minority Interest ₹ 105 (in'000s); Cost of control ₹ 40 (in'000s)]

Question 2

The Balance Sheets of Bat Ltd. and Ball Ltd. as on 31.3.2017 are as follows:

	Bat Ltd. ₹	Ball Ltd. ₹		Bat Ltd. ₹	Ball Ltd. ₹
Share Capital			Investments		
(Shares of ₹ 10 each)	1,60,000	2,00,000	Shares in Ball Ltd.	1,96,000	–
Profit and Loss account	50,000	60,000	Trade receivables	–	1,20,000
Trade payables	–	16,000	Inventory	–	80,000
			Cash at Bank	–	70,000
			Cash in hand	14,000	6,000
	2,10,000	2,76,000		2,10,000	2,76,000

Particulars of Bat Ltd.:

(1) *This company was formed on 1.4.2016.*

(2) *It acquired the shares of Ball Ltd. as under:*

Date of Acquisition	No. of Shares	Cost ₹
1.4.2016	8,000	1,10,000
31.7.2016	6,000	86,000

(3) *The shares purchased on 31.7.2016 are ex-dividend and ex-bonus from existing holders.*

(4) *On 31.7.2016 dividend at 10% was received from Ball Ltd. and was credited to Profit and Loss Account.*

(5) *On 31.7.2016 it received bonus shares from Ball Ltd. in the ratio of one share on every four shares held.*

(6) *Bat Ltd. incurred an expenditure of ₹ 500 per month on behalf of Ball Ltd. and this was debited to the Profit and Loss Account of Bat Ltd., but nothing has been done in the books of Ball Ltd.*

(7) *The balance in the Profit and Loss Account as on 31.3.2017 included ₹ 36,000 being the net profit made during the year.*

(8) *Dividend declared for 2016-2017 at 10% was not provided for as yet.*

Particulars of Ball Ltd.:

(1) *The balance in the Profit and Loss Account as on 31.3.2017 is after the issue of bonus shares made on 31.7.2016.*

(2) *The net profit made during the year is ₹ 24,000 including ₹ 6,000 received from insurance company in settlement of the claim towards loss of inventory by fire on 30.06.2016 (Cost ₹ 10,800 included in opening inventory).*

(3) *Dividend declared for 2016-2017 at 10% was not provided for in the accounts.*

Prepare the Consolidated Balance Sheet of Bat Ltd. as on 31.3.2017.

[Answer: CBS Total ₹ 2,90,000; Minority Interest ₹ 50,800; Cost of control (₹ 3,040)]

Question 3

The summarised Balance Sheets of A Ltd. and B Limited are as follows:

Balance Sheets as at 31st December, 2016

	A Ltd.	B Ltd.
Sources of Funds:	₹	₹
Share Capital in equity shares of ₹ 10 each	2,00,000	50,000
Reserves	20,000	5,000
Profit and Loss Account as on 1st January, 2016	30,000	10,000
Profit for the year	8,000	8,000
Add: Dividends from B Ltd.	4,000	–
Less: Dividends paid	–	(5,000)
Trade payables	30,000	20,000
Total	2,92,000	88,000
Application of Funds:		
Fixed Assets	2,00,000	80,000
Current Assets	32,000	8,000
Shares in B Ltd. at cost – 3,000 shares	60,000	–
Total	2,92,000	88,000

A Limited had acquired 4,000 shares in B Ltd. at ₹ 20 each on 1st January, 2016 and sold 1,000 of them at the same price on 1st October, 2016. The sale is cum dividend. An interim dividend of 10% was paid by B Limited on 1st July, 2016.

Draft the consolidated Balance Sheet as at 31st December, 2016.

[Answer: CBS Total ₹ 3,41,000; Minority Interest ₹ 27,200; Cost of control ₹ 21,000]

Question 4

Astha Ltd. acquired 80% of both classes of shares in Birat Ltd. on 1.4.2016. The draft Balance Sheets of two companies on 31st March, 2017 were as follows:

(₹ in 000's)

Liabilities	Astha Ltd.	Birat Ltd.	Assets	Astha Ltd.	Birat Ltd.
Share Capital:					
Equity shares of ₹ 10 each, full paid up	3,000	600	Plant & machinery	2,060	600
14% Preference shares of ₹ 100 each, fully paid up	-	400	Furniture & fixtures	600	540

General reserve	*1,900*	*40*	*Investments in equity shares of Birat Ltd.*	*1,920*	*-*
Profit and loss account	*1,600*	*720*	*in preference shares of Birat Ltd.*	*320*	*-*
Trade payables	*300*	*320*	*Inventory*	*680*	*404*
			Trade receivabless	*560*	*316*
			Cash at bank	*660*	*220*
	6,800	*2,080*		*6,800*	*2,080*

Note: *Contingent liability – Astha Ltd.: Claim for damages lodged by a contractor against the company pending in a law-suit – ₹ 1,55,000.*

Additional Information:

(i) General reserve balance of Birat Ltd. was the same as on 1.4.2016.

(ii) The balance in Profit and Loss A/c of Birat Ltd. on 1.4.2016 was ₹3,20,000, out of which dividend of 16% p.a. on the Equity capital of ₹6,00,000 was paid for the year 2015-2016.

(iii) The dividend in respect of preference shares of Birat Ltd. for the year 2016-2017 was still payable as on 31.3.2017.

(iv) Astha Ltd. credited its Profit and Loss A/c for the dividend received by it from Birat Ltd. for the year 2015-2016.

(v) Trade payables of Astha Ltd. included an amount of ₹1,20,000 for purchases from Birat Ltd., on which the later company made a loss of ₹10,000.

(vi) Half of the above goods were still with the closing inventory of Astha Ltd. as at 31.3.2017.

(vii) At the time of acquisition by Astha Ltd., while determining the price to be paid for the shares in Birat Ltd. it was considered that the value of plant and machinery was to be increased by 25% and that of furniture and fixtures reduced to 80%. There was no transaction of purchase or sale of these assets during the year. The directors wish to give effect to these revaluations in the consolidated balance sheet.

(viii) The directors of Astha Ltd. are of opinion that disclosure of its contingent liability will seriously prejudice the company's position in dispute with the contractor.

Prepare consolidated balance sheet as at 31st March, 2017, assuming the rate of depreciation charged as 25% p.a. and 10% p.a. on plant and machinery and furniture and fixtures respectively. Also assume that the preference shares given in the question are non-convertible in the nature. Workings should be part of the answer.

[Answer: CBS Total ₹ 7,655; Minority Interest ₹ 360.4; Cost of control ₹ 1,088]

Question 5

The Balance Sheets of Aqua Ltd. and Baqa Ltd. as on the dates of last closing of accounts are as under:

	Aqua Ltd. as on 31.03.2017 ₹	Baqa Ltd. as on 31.12.2016 ₹
Liabilities		
Share capital (equity shares of ₹10 each)	11,00,000	5,00,000
Accumulated Profits & Reserves	4,50,000	2,05,000
15% ₹100 non-convertible debentures	-	3,00,000
Accounts Payable	4,80,000	2,80,000
Other liabilities	1,00,000	40,000
Tax Provision	1,50,000	2,50,000
Total	22,80,000	15,75,000
Assets		
Fixed Assets at Cost	8,45,000	5,26,500
Less: Depreciation	(1,95,000)	(1,21,500)
	6,50,000	4,05,000
Investments:		
40,000 shares in Baqa Ltd.	8,00,000	–
1,000 debentures in Baqa Ltd.	1,50,000	–
Current Assets:		
Inventories	2,00,000	3,50,000
Accounts Receivable	2,50,000	4,65,000
Cash & Bank	2,30,000	3,55,000
Total	22,80,000	15,75,000

The following information is also available:

1. *On 8th February, 2017 there was a fire at the factory of Baqa Ltd., resulting in inventory worth ₹ 20,000 being destroyed. Baqa received 75 per cent of the loss as insurance.*
2. *The same fire resulted in destruction of a machine having a written down value of ₹ 1,00,000. The Insurance company admitted the Company's claim to the extent of 80 per cent. The machine was insured at its fair value of ₹ 1,50,000.*
3. *On 13th March, 2017, Aqua sold goods costing ₹ 1,50,000 to Baqa at a mark-up of 20 per cent. Half of these goods were resold to Aqua who in turn was able to liquidate the entire inventory of such goods before closure of accounts on 31st March, 2017. As on 31st March, 2017, Baqa's accounts payable show ₹ 60,000 due to Aqua on the two transactions.*
4. *Aqua acquired the holdings in Baqa on 1st January, 2015 when the reserves and accumulated profits of Baqa Ltd. stood at ₹ 75,000.*
5. *Both Companies have not provided for tax on current year profits. The current year taxable profits are ₹ 33,000 and ₹ 66,000 for Aqua Ltd. and Baqa Ltd. respectively. The tax rate is 33%.*

6. *The incremental profits earned by Baqa Ltd. for the period January, 2017 to March 2017 over that earned in the corresponding period in 2016 was ₹ 56,000. Except for the profits that resulted from the transactions with Aqua in the aforesaid period, the entire profits have been realised in cash before 31st March, 2017.*

You are requested to consolidate the accounts of the two companies and prepare a Consolidated Balance Sheet of Aqua Limited and its subsidiary as at 31st March, 2017.

[Answer: CBS Total ₹ 33,51,000; Minority Interest ₹ 1,50,844; Cost of control ₹ 3,90,000]

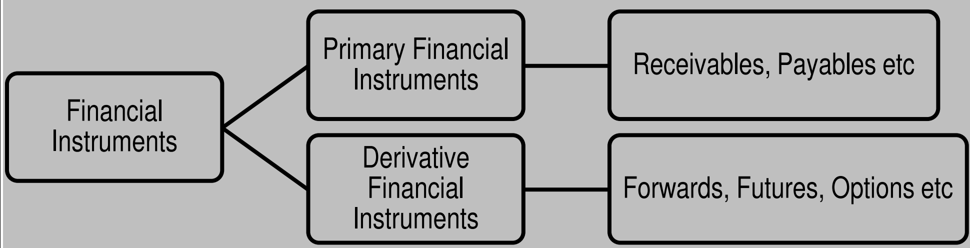
6

Accounting and Reporting of Financial Instruments

BASIC CONCEPTS

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

Financial Instruments may be classified as primary and derivative financial instruments. The classifications can be shown as:



A financial asset is any asset that is

(a) cash,

(b) an equity instrument of another entity,

(c) a contractual right to:

   (i) receive

   - cash or
   - another financial asset from another entity; or

   (ii) to exchange financial assets or financial liabilities with another entity under conditions that are ***potentially favourable*** to the entity; or

(d) a contract that ***will or may be*** settled in the entity's ***own equity instruments*** and is:

   (i) a ***non-derivative*** for which the entity is or may be obliged to receive a ***variable number*** of the entity's own equity instruments; or

   (ii) a ***derivative*** that will or may be settled ***other than by*** the exchange of a fixed amount of cash or another financial asset for a ***fixed number*** of the entity's own equity instruments.

A financial liability is any liability that is:

(a) A contractual obligation:

(i) to deliver

- cash or
- **another financial asset** to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are **potentially unfavourable** to the entity; or

(b) a contract that **will or may be** settled in the entity's own equity instruments and is:

i. a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

ii. a **derivative** that will or may be settled **other than** by the exchange of a fixed amount of cash or another financial asset for a **fixed number** of the entity's own equity instruments.

Note:

1. A contractual right or contractual obligation to receive, deliver or exchange financial instruments is itself a financial instrument.
2. A ***chain*** of contractual rights or contractual obligations meets the definition of a financial instrument if it will ***ultimately lead to the receipt or payment of cash*** or to the acquisition or issue of an equity instrument.
3. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute or contingent on the occurrence of a future event.
4. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though such assets and liabilities are not always recognised in the financial statements.

Meaning of Equity Instrument

An equity instrument is any contract that evidences a ***residual interest*** in the assets of an entity after deducting all of its liabilities.

Preference Shares

Preference shares may be issued with various rights.

In determining whether a preference share is a financial liability or an equity instrument, an issuer assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability.

Preference share is the name given to any share that has some preferential rights in relation to other classes of shares, particularly in relation to ordinary shares. These preferential rights are of great variety, but refer normally to the right to a fixed dividend, although they could also refer to the right on winding up to receive a fixed part of the capital or otherwise to participate in the distribution of the company's assets (share with such rights are often known as participating preference shares).

When distributions to holders of the preference shares, whether cumulative or non-cumulative, are at the **discretion of the issuer**, the shares are equity instruments.

Derivatives

Financial instrument or other contract within the scope of this Standard with all three of the following characteristics.

1. Its value changes in response to the change in an underlying which can be a specified interest rate, financial instrument price, commodity price, foreign exchange rate, prices of indices, credit rating or credit index, or other variable provided in the case of a non-financial variables.
2. It requires no initial or very less investment than it would be required otherwise to enter into a contract in normal course.
3. It is settled at a future period. The settlement can either by delivery of the underlying or cash settlement. In case of cash settlement no delivery of underlying takes place rather difference is settled in cash.

Forward Contracts

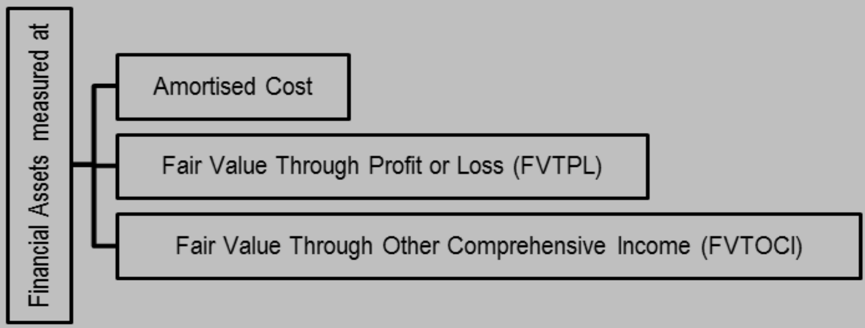
Forward Contract is the simplest form of a Derivatives Contract. Basically forward contract is a valid contract settled at some future point of time.

Option

As mentioned above both parties to a forward contract have an obligation to perform at the agreed time. However under Option contract the option-holder has a right not an obligation to exchange the financial asset but the writer (seller) of the option has the obligation to exchange the financial asset upon exercise of the option. The nature of the holder's right and writer's obligation are not affected by the likelihood that the option will be exercised.

Thus, the purchaser has a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written. The seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). Both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

1. Classification of Financial Assets



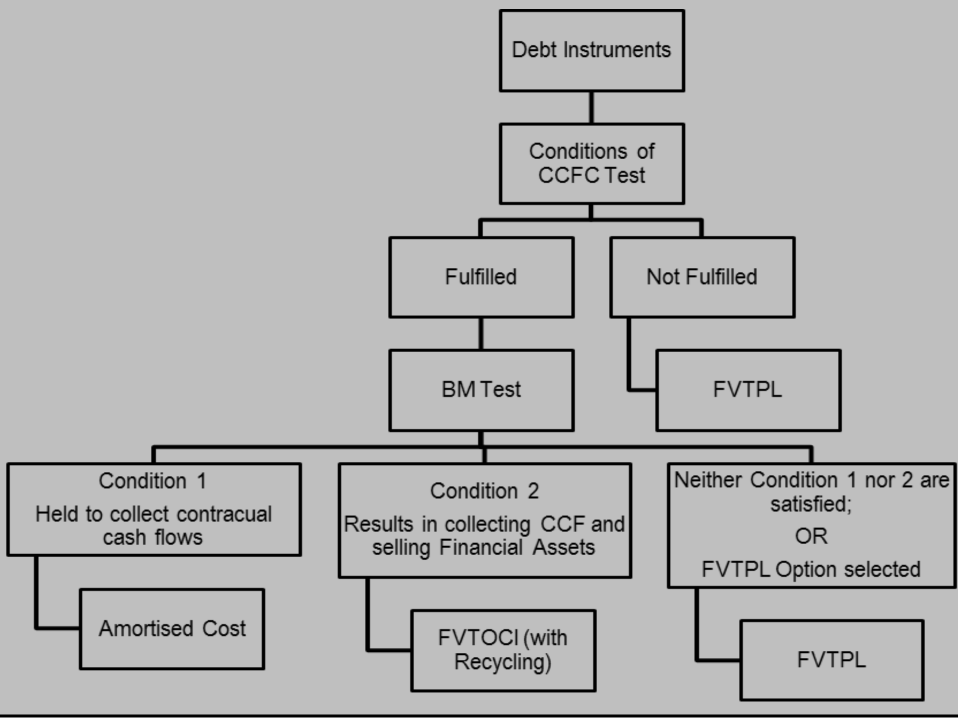
An entity shall classify financial assets depending upon the ***following 2 criteria and options*** elected by the entity:

(a) the entity's **Business Model (BM)** for managing the financial assets and

(b) the Contractual Cash Flow Characteristics (CCFC) of the financial asset

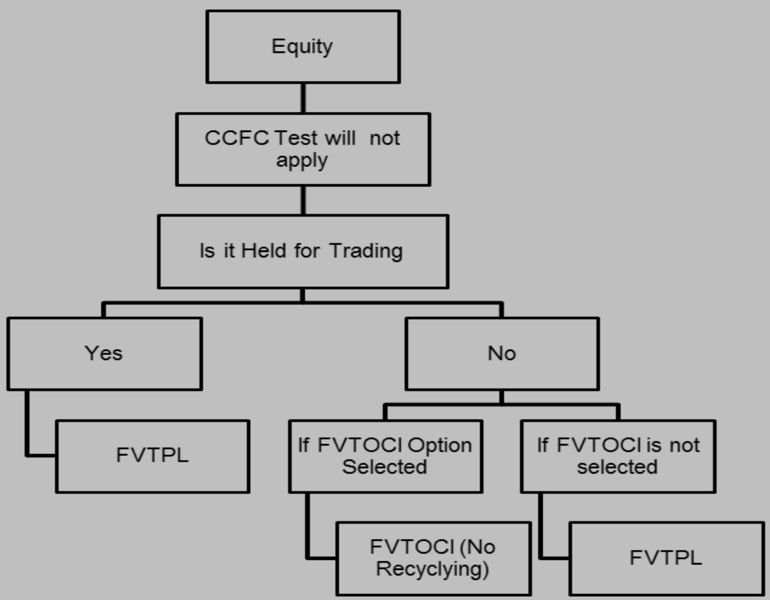
1.1 Classification of Debt Instruments (Financial Assets)

Classification of Debt Instruments has been explain by way of following flowchart:



1.2 Classification of Equity (Financial Asset)

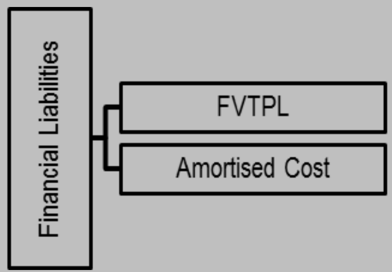
Classification of Equity which is a Financial Asset has been explained as follows:



1.3 Classification of Derivatives (Financial Asset)

Derivative classified as financial asset would be measured at Fair Value Through Profit and Loss (FVTPL) only. The classification of derivatives is only as per one basis i.e. Fair Value Through Profit and Loss (FVTPL)

2. Classification of Financial Liabilities



Financial Liabilities are classified as financial liability measured at fair value through profit or loss and financial liability measured at amortised cost.

Recognition of Financial Instrument

Initial recognition

An entity shall recognise a financial asset or a financial liability in its balance sheet when, and only when, the entity becomes party to the contractual provisions of the instrument.

Trade Date

The trade date is the date that an entity **commits itself to purchase or sell an asset**.

Settlement Date

The settlement date is the date that an **asset is delivered to or by an entity.**

When settlement date accounting is applied an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset.

Initial measurement

At **initial recognition**, an entity shall measure a financial asset or financial liability at its **fair value plus or minus**, in the case of a financial asset or financial liability subsequently not measured at fair value through profit or loss, **transaction costs** that are directly attributable to the acquisition or issue of the financial asset or financial liability.

Reclassification of Financial Assets and Liabilities

When, and only when, an entity **changes its business model for managing** financial assets it shall reclassify all affected financial assets.

If an entity reclassifies financial assets, it shall apply the reclassification **prospectively** from the reclassification date.

The entity shall **not restate** any previously recognised gains, losses (including impairment gains or losses) or interest.

An entity shall derecognise a financial asset **when, and only when:**

a) the contractual rights to the cash flows from the financial asset expire, or

b) it transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6 of Ind AS 109.

On derecognition of a financial asset in its entirety, the difference between:

a) the carrying amount (measured at the date of derecognition) and

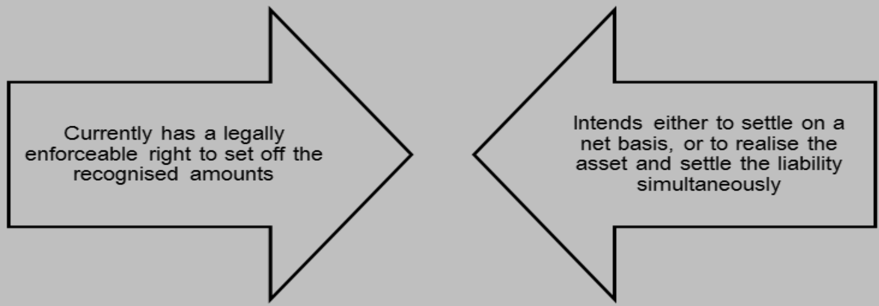
b) the consideration received (including any new asset obtained less any new liability assumed) shall be recognised in profit or loss.

Embedded Derivatives

An embedded derivative is a component of a hybrid contract that also includes a non-derivative host—with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty, is not an embedded derivative, but a separate financial instrument.

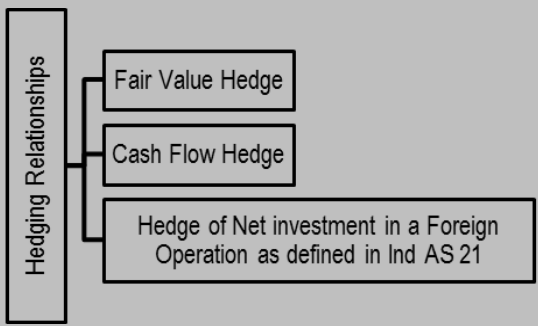
A financial asset and a financial liability shall be offset and the net amount presented in the balance sheet when, and only when, an entity:



Types of Hedging Relationships

An entity applies hedge accounting to hedging relationships that meet the qualifying criteria.

There are three types of hedging relationships:



1. Fair value hedge

A hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

2 Cash flow hedge

A hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and could affect profit or loss.

3 Hedge of a Net Investment in a Foreign Operation as Defined in Ind AS 21

Hedges of a net investment in a foreign operation, including a hedge of a monetary item that is accounted for as part of the net investment

Illustration 1

A Company has issued 9% mandatorily redeemable preference shares with mandatory fixed dividends. Evaluate whether such preference shares are an equity instrument or a financial liability to the issuer entity?

Solution

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attaching to the instrument's principal and return components.

The instrument in the question provides for mandatory periodic fixed dividend payments and mandatory redemption by the issuer for a fixed amount at a fixed future date. Since there is a contractual obligation to deliver cash (for both dividends and repayment of principal) to the shareholder that cannot be avoided, the instrument is a financial liability in its entirety.

Illustration 2

An entity is about to purchase a portfolio of fixed rate assets that will be financed by fixed rate debentures. Both financial assets and financial liabilities are subject to the same interest rate risk that gives rise to opposite changes in fair value that tend to offset each other. Comment?

Solution

In the absence of the fair value option, the entity may have classified the fixed rate assets as FVTOCI with gains and losses on changes in fair value recognised in other comprehensive income and the fixed rate debentures at amortised cost. Reporting both the assets and the liabilities at fair value through profit and loss i.e. FVTPL corrects the measurement inconsistency and produces more relevant information.

Illustration 3

Entity ABC enters into a fixed price forward contract to purchase 50,00,000 kilograms of copper in accordance with its expected usage requirements.

The contract permits ABC to take physical delivery of the copper at the end of 12 months or to pay or receive a net settlement in cash, based on the change in fair value of copper. Is the contract covered under Financial Instruments standard?

Solution

The above contract needs to be evaluated to determine whether it falls within the scope of the financial instruments standards.

The contract is a derivative instrument because there is no initial net investment, the contract is based on the price of copper and it is to be settled at a future date.

However, if ABC intends to settle the contract by taking delivery and has no history for similar contracts of settling net in cash, or of taking delivery of the copper and selling it within a short period after delivery for the purpose of generating a profit from short term fluctuations in price or dealer's margin, the contract is not accounted for as a derivative under Ind AS 109.

Instead, it is accounted for as an executory contract and if it becomes onerous then Ind AS 37 would apply.

Illustration 4

Entity X holds an option to purchase equity shares in a listed entity Y for ₹ 100 per share at the end of a 120 day period. Evaluate the contract whether a financial asset or a financial liability? What if the entity X has written the option?

Solution

The above call option gives entity X, a contractual right to exchange cash of ₹ 100 for an equity share in another entity and will be exercised if the market value of the share exceeds ₹100 at the end of the 120 day period. If the market value of a share will be such that the entity X will gain on the exercise date, it will exercise the call option.

Since entity X stands to gain if the call option is exercised, the exchange is potentially favourable to the entity. Therefore, the option is a derivative financial asset from the time the entity becomes a party to the option contract.

On the other hand, if entity X writes an option under which the counterparty can force the entity to sell equity shares in the listed entity Y for ₹ 100 per share at any time in the next 120 days, then entity X will be said to have a contractual obligation to exchange its equity shares to another entity for cash of ₹ 100 per share on potentially unfavourable terms i.e. if the holder exercises the option, on account of the market price per share being above the exercise price of ₹ 100 per share at the end of the 120 day period.

Since entity X stands to lose if the option is exercised, the exchange is potentially unfavourable and the option is a derivative financial liability from the time the entity becomes a party to the option contract.

Illustration 5

Entity X (the transferor) holds a portfolio of receivables with a carrying value of ₹1,00,000. It enters into a factoring arrangement with entity Y (the transferee) under which it transfers the portfolio to entity Y in exchange for ₹90,000 of cash.

Entity Y will service the loans after their transfer and debtors will pay amounts due directly to entity Y. Entity X has no obligations whatsoever to repay any sums received from the factor and has no rights to any additional sums regardless of the timing or the level of collection from the underlying debts. Evaluate

Solution

Entity X has transferred its rights to receive the cash flows from the asset via an assignment to entity Y. Furthermore, as entity Y has no recourse to entity X for either late payment risk or credit risk, entity X has transferred substantially all the risks and rewards of ownership of the portfolio.

Hence, entity X derecognises the entire portfolio. The difference between the carrying value of ₹1,00,000 and cash received of ₹90,000 i.e. ₹10,000 is recognised immediately as a financing cost in profit or loss.

Had Entity X not transferred its rights to receive the cash flows from the asset or there would have been any credit default guarantee given by entity X, then it would have not led to complete transfer of risk and rewards and entity X could not derecognise the portfolio due to the same.

Illustration 6

Entity G places its privately held ordinary shares that are classified as equity with a stock exchange and simultaneously raises new capital by issuing new ordinary shares on the stock exchange.

Transaction costs are incurred in respect of both transactions. Determine the treatment of the incurred transactions costs?

Solution

Since the issue of new shares is the issue of an equity instrument, but the placing of the existing equity instruments with the exchange is not, the transaction costs will need to be allocated between the two transactions.

Transaction costs in respect of the new shares issued will be recognised in equity whereas the transaction costs incurred in placing the existing shares with the stock exchange will be recognised in profit or loss.

Illustration 7

An entity issues a non-redeemable callable subordinated bond with a fixed 8% coupon. The coupon can be deferred in perpetuity at the issuer's option. The issuer has a history of paying the coupon each year and the current bond price is predicated on the holders expectation that the coupon will continue to be paid each year. In addition the stated policy of the issuer is that the coupon will be paid each year, which has been publicly communicated. Evaluate?

Solution

Although there is both pressure on the issuer to pay the coupon, to maintain the bond price, and a constructive obligation to pay the coupon, there is no contractual obligation to do so. Therefore the bond is classified as an equity instrument.

Illustration 8

A zero coupon bond is an instrument where no interest is payable during the instrument's life and that is normally issued at a deep discount to the value at which it will be redeemed. Evaluate?

Solution

Although there are no mandatory periodic interest payments, the instrument provides for mandatory redemption by the issuer for a determinable amount at a fixed or determinable future date. Since there is a contractual obligation to deliver cash for the value at which the bond will be redeemed, the instrument is classified as a financial liability.

Illustration 9

On 30th March 2015 an entity enters into an agreement to purchase a Financial Asset for ₹ 1,000 which is the Fair Value on that date.

On Balance Sheet date i.e. 31/3/2017 the Fair Value is ₹1,020 and on Settlement date i.e. 2/4/2017 Fair Value is ₹ 1,030.

Pass necessary Journal entries on trade date and settlement date when the asset acquired is measured at

(a) Amortised cost

(b) FVTPL

(c) FVTOCI.

Solution

Case (a) (i) Financial Asset at Amortised Cost – Trade Date Accounting

Dates	Journal Entry		Amount	Amount
			(₹)	(₹)
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	No Entry			
2/4/2017	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at Amortised Cost – Settlement Date Accounting

Dates	Journal Entry		Amount	Amount
			(₹)	(₹)
30/3/2017	No Entry			
31/3/2017	No Entry			
2/4/2017	Financial Asset	Dr.	1,000	
	To Cash			1,000

Case (b) (i) Financial Asset at FVTPL – Trade Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	Financial Asset	Dr.	20	
	To P&L			20
2/4/2017	Financial Asset	Dr.	10	
	To P&L			10
	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at FVTPL– Settlement Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	No Entry			
31/3/2017	Fair Value Change	Dr.	20	
	To P&L			20
2/4/2017	Fair Value Change	Dr.	10	
	To P&L			10
	Financial Asset	Dr.	1,030	
	To Cash			1,000
	To Fair Value Change			30

Case (c) (i) Financial Asset at FVTOCI – Trade Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	Financial Asset	Dr.	1,000	
	To Payables			1,000
31/3/2017	Financial Asset	Dr.	20	
	To OCI			20
2/4/2017	Financial Asset	Dr.	10	
	To OCI			10
	Payables	Dr.	1,000	
	To Cash			1,000

(ii) Financial Asset at FVTOCI – Settlement Date Accounting

Dates	*Journal Entry*		*Amount*	*Amount*
			(₹)	*(₹)*
30/3/2017	No Entry			
31/3/2017	Fair Value Change	Dr.	20	
	To OCI			20
2/4/2017	Fair Value Change	Dr.	10	
	To OCI			10
	Financial Asset	Dr.	1,030	
	To Cash			1,000
	To Fair Value Change			30

Illustration 10

A Company invested in Equity shares of another entity on 15th March for ₹20,000. Transaction Cost = ₹400 (not included in ₹20,000)

Fair Value on Balance Sheet date i.e. 31st March 2017 = ₹24,000. Pass necessary Journal Entries when Financial Asset is accounted as FVTPL.

Solution

Date	**Particulars**		**(₹)**	**(₹)**
15/3/2017	Investment A/c	Dr.	20,000	
	Transaction Cost A/c	Dr.	400	
	To Bank			20,400
31/3/2017	Investment A/c	Dr.	4,000	
	To Fair Value Gain A/c			4,000
31/3/2017	P&L A/c	Dr.	400	
	To Transaction Cost A/c			400
31/3/2017	Fair Value Gain A/c	Dr.	4,000	
	To P&L A/c			4,000

Illustration 11

A Company invested in Equity shares of another entity on 15th March for ₹50,000. Transaction Cost = ₹1,000 (not included in ₹50,000). Fair Value on Balance Sheet date i.e. 31st March 2017 = ₹60,000. Pass necessary Journal entries when Financial Asset is accounted as FVTOCI.

Solution

Date	*Particulars*		*(₹)*	*(₹)*
15/3/2017	Investment A/c To Bank	Dr.	51,000	 51,000
31/3/2017	Investment A/c To Fair Value Gain A/c	Dr.	9,000	 9,000
31/3/2017	Fair Value Gain A/c To OCI A/c	Dr.	9,000	 9,000
31/3/2017	OCI A/c To Fair Value Reserve A/c	Dr.	9,000	 9,000

Illustration 12

A Company lends ₹ 10 lacs to another company @ 12% p.a. interest on 1/4/2017.

It incurs ₹ 4,000 incremental costs for documentation.

Loan tenure = 5 years with Interest charged annually.

Fair Value of Loan = ₹9,94,000. Pass necessary Journal entries when Financial Asset is accounted as Amortised Cost. Assume that interest rate is based on market rate of interest.

Solution

Date	*Particulars*		*(₹)*	*(₹)*
1/4/2017	Loan A/c To Bank A/c	Dr.	10,00,000	 10,00,000
1/4/2017	Loan Processing Expense A/c To Bank A/c	Dr.	4,000	 4,000
1/4/2017	Loan A/c To Loan Processing Expense A/c	Dr.	4,000	 4,000

Illustration 13

On 1st April, 2017, Alpha Ltd. issued ₹ 30,00,000, 6% convertible debentures of face value of ₹ 100 per debenture at par. The debentures are redeemable at a premium of 10% on 31.03.2021 or these may be converted into ordinary shares at the option of the holder, the interest rate for equivalent debentures without conversion rights would have been 10%.

Being compound financial instrument, you are required to separate equity and debt portion as on 01.04.2017.

Solution

Computation of Equity and Debt Component of Convertible Debentures as on 1.4.2017

	₹
Present value of the principal repayable after four years	22,44,000
[30,00,000 x 1.10 x .680 at 10% Discount factor]	
Present value of Interest	5,70,600
[1,80,000 x 3.17 (4 years cumulative 10% discount factor)]	
Value of debt component	28,14,600
Value of equity component	1,85,400
Proceeds of the issue	30,00,000

Illustration 14

A company borrowed a sum of ₹ 85 lakhs for its expansion. The terms of loan were as follows:

(i) Tenure of the loan will be 10 years.

(ii) Interest is payable @ 12% p.a. and the principal is repayable at the end of 10th year.

The company defaulted in the payment of interest for the year 4, 5 and 6.

A loan reschedule agreement took place at the end of 7th year. As per the agreement the company is required to pay ₹ 150 lakhs at the end of 8th year.

You are required to calculate the additional amount to be paid on account of rescheduling and also the book value of the loan at the end of 8th year when reschedule took place assuming that interest will be compounded in case of default.

Solution

Outstanding Amount at the end of 8th year = ₹ 85,00,000 x 1.12 x 1.12 x 1.12 x 1.12 x 1.12
= ₹ 1,49,79,904 (i.e. adding interest for 4th to 8th year)

Rescheduled amount to be paid at the end of the 8th year = ₹ 1,50,00,000

Additional amount to be paid on rescheduling = ₹ 1,50,00,000 - ₹ 1,49,79,904
= ₹ 20,096.

At the end of the 8th year, book value of loan will become Nil.

Note: In the above solution it is assumed that interest due for the 7th and 8th year have also not been paid.

7

Share Based Payments

BASIC CONCEPTS

Share based payments cover all forms of share-based payment for goods and services supplied to the reporting entity, including:

- employee share or share option schemes – employees are defined widely and include others providing similar services
- share-based payments to parties other than employees that have supplied goods or services to the entity
- payments to be settled in cash or other assets at amounts that depend on share values, eg share appreciation rights.

Share Based Payment Plans

Share-based payment plans generally take the form of Employee Stock Option Plans (ESOP), Employee Stock Purchase Plans (ESPP) and Stock Appreciation Rights (SAR).

These are being defined as follows:

a) **The Employee Stock Option Plan (ESOP)** is a contract that gives the employees of an enterprise the right, but not obligation, for a specified period to purchase or subscribe to the specified number shares of the enterprise at a fixed or determinable price, called the exercise price.

b) **The Employee Stock Purchase Plan (ESPP),** is a plan under which the enterprise offers shares to its employees at a discounted price as part of public issue or otherwise.

c) **The Stock Appreciation Rights (SAR)** are rights that entitle the employees to receive cash or shares for an amount equivalent to the excess of market price on exercise date over a stated price.

Accounting Approach-For accounting purposes, employee share-based payment plans are classified into the following categories:

(a) **Equity- settled**: Under these plans, the employees receive shares, e.g. ESOP

(b) **Cash-settled**: Under these plans, the employees receive cash based on the price (or value) of the enterprise's shares, e.g. Stock Appreciation Rights (SAR).

(c) **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.

I. Accounting procedure for ESOP

The amount recognised as expense in a period is debited to 'Employees' Compensation A/c' with a corresponding credit to an equity account called 'Stock Options Outstanding A/c' which may ultimately be transferred to share capital, securities premium account and/or general reserve at the time of settlement.

Disclosure: Till such transfer, the credit balance of Stock Options Outstanding A/c is shown in balance sheet under a separate heading, between 'Share Capital' and 'Reserves and Surplus'.

Accounting for Balance option not excercised- the balance of Employees' Compensation A/c is transferred to the Profit & Loss A/c of the period.

On exercise of the option, the consideration for such shares comprises of the exercise price and the aggregate value of option recognised as expense, standing to the credit of Stock Options Outstanding A/c. In a situation where the right to obtain shares or stock options expires unexercised, the balance standing to the credit of the relevant equity account should be transferred to General Reserve.

Variation in vesting period

In case of revision of vesting period, the basis of allocation of option value to a particular accounting period should be based on revised estimate of vesting period.

Where the vesting condition is a market condition, the fair value of option is reduced due to the possibility that the vesting condition may not be satisfied. Such fair values are recognised as expense whether or not the market condition is satisfied, over the vesting period estimated on grant date. The estimates of vesting periods are not revised subsequently in these cases.

Graded Vesting

Graded vesting refers to a situation where options under a plan vest on different dates. Since one of the factors affecting fair value of an option is expected life, the fair value for each group should be computed separately. Fair value of a group is then allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

In the same way as fair value, intrinsic value of a group is allocated to accounting periods and recognised as expense for the period with reference to vesting period for the group.

II. Employees' Stock Purchase Plans (ESPP)

Under these plans, employees are given an option to subscribe to shares of employer in a public issue or otherwise. The exercise price is set at a specified rate of discount on the issue price/ market price on the date of exercise. The fair value of ESPP is recognised over the vesting period in the same way as ESOP.

Modifications

If the modification reduces the fair value of the options granted, the modification should be ignored.

If the modification increases the fair value of the options granted (e.g., when exercise price is reduced), the **incremental fair value** is recognised as expense over the remaining vesting period.

Incremental fair value is the difference between (i) fair value of the modified option estimated on the date of the modification and (ii) fair value of the original option estimated on the date of modification.

When to recognise incremental fair value - If the modification occurs after the vesting date, the incremental fair value is recognised immediately, or over the additional vesting period if the employee is required to complete an additional period of service before becoming unconditionally entitled to the options.

Cancellation and settlements during vesting period

If an enterprise cancels or settles a grant of shares or stock options during the vesting period (other than a grant cancelled by forfeiture when the vesting conditions are not satisfied):

(a) The entire amount of unamortised value of option should be recognised immediately.

(b) Payments made to the employees on cancellation or settlement should be debited to ESOP Outstanding A/c to the maximum extent of fair value of options granted, measured at the cancellation / settlement date. Any payment in excess of the fair value is recognised as an expense.

(c) If new options are granted to the employees in replacement for the cancelled options, the replacement is regarded as modification. The net fair value of the cancelled option is their fair value, immediately before the cancellation, less the amount of any payment made to the employee on cancellation that is debited to ESOP Outstanding A/c, in accordance with (b) above.

Dilution of Earning per share (EPS) due to ESOP granted-Applicability of AS-20

Dilution occurs when expected proportionate increase in number of shares is more than expected proportionate increase in profit available to equity shareholders. This happens because issue of shares at less than fair value implies issue of certain number of shares for no consideration. These shares are taken in computation of diluted EPS as potential equity.

$$\text{Number of shares issued for consideration} = \frac{\text{Expected issue proceeds}}{\text{Fair value per share}}$$

No. of shares issued for no consideration = No. of shares issued – No. of shares issued for consideration

Issue of shares under a scheme of share-based payment, increases the number of shares outstanding. Since the shares are issued at exercise price, which is lower than the fair value of shares issued, an ESOP gives rise to situation of dilution of EPS. In calculating the number of shares issued for no consideration, the expected proceeds from the exercise of option is taken as sum of (i) Exercise Price (ii) Value of services to be rendered by employees in future upto the vesting date. This value of services is measured as unamortised value of option.

III. Stock Appreciation Rights (SAR)

Stock Appreciation Rights (SAR) entitle the employees to claim cash payment to the extent of excess of market price of underlying shares on exercise date over the exercise price. The accounting procedures for ESOP and SAR are similar except that: (i) The liability for SAR is recognised as Provision instead of ESOP Outstanding and (ii) value per option is reassessed at each reporting date.

Employee Share-Based Payment Plans With Cash Alternatives

These plans consist of two components viz., (i) liability, i.e., the employer's obligation to pay price differential in cash and (ii) equity, i.e., the employer's obligation to issue shares at exercise price. The company should first measure, on the grant date, fair value of the plan on the assumption that all employees will exercise their options in favour of (i) cash settlement (ii) equity settlement. The fair value of plan for cash settlement is the fair value of the liability component. The excess, if any, of fair value of plan for equity settlement over the liability component is the fair value of equity component. The accounting procedure for equity component is same as that for ESOP. The accounting procedure for liability component is same as that for SAR.

On the date of settlement, the company should remeasure the liability to its fair value. If the employees opt for shares, the amount of liability should be treated as the consideration for the shares issued. If the employees opt for cash settlement, the balance in ESOP Outstanding A/c should be transferred to general reserve.

Question 1

Choice Ltd. grants 100 stock options to each of its 1,000 employees on 1.4.2014 for ₹ 20, depending upon the employees at the time of vesting of options. The market price of the share is ₹ 50. 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 31.3.2015. 4,000 unvested options lapsed on 313.2016 and finally 3,500 unvested options lapsed on 31.3.2017.

Following is the earning of Choice Ltd.:

Year ended on	*Earning (in %)*
31.3.2015	*14%*

31.3.2016	*10%*
31.3.2017	*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.

Answer

Journal Entries

Date	*Particulars*		₹	₹
31.3.2015	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.)			
31.3.2015	Profit and Loss Account	Dr.	14,25,000	
	To Employees compensation expenses A/c			14,25,000
	(Being compensation expense charged to Profit & Loss A/c)			
31.3.2016	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.)			
31.3.2016	Profit and Loss Account	Dr.	3,95,000	
	To Employees compensation expenses A/c			3,95,000
	(Being compensation expense charged to Profit & Loss A/c)			
31.3.2017	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.)			
31.3.2017	Bank A/c (85,000 X ₹20)	Dr.	17,00,000	
	ESOS outstanding A/c [(26,25,000/87,500) x 85,000]	Dr.	25,50,000	

	To Equity share capital (85,000 x ₹ 10)			8,50,000
	To Securities premium A/c (85,000 x ₹40)			34,00,000
	(Being 85,000 options exercised at an exercise price of ₹ 50 each)			
	Profit and Loss A/c Dr.		8,05,000	
	To Employees compensation expenses A/c			8,05,000
	(Being compensation expenses charged to Profit & Loss A/c)			
	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 recognised

Particulars	*Year 1 (31.3.2015)*	*Year 2 (31.3.2016)*	*Year 3 (31.3.2017)*
Expected vesting period (at the end of the year)	2nd year	3rd year	3rd year
Number of options expected to vest	95,000 options	91,000 options	87,500 options
Total compensation expenses accrued @ 30 (i.e. 50-20)	₹ 28,50,000	₹ 27,30,000	₹ 26,25,000
Compensation expenses 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 expenses 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

Question 2

ABC Ltd. grants 1,000 employees stock options on 1.4.2013 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 lapsed on 1.5.2015. 600 options were exercised on 30.6.2016. 100 vested options lapsed at the end of the exercise period. Pass Journal Entries giving suitable narrations.

Answer

Journal Entries in the books of ABC Ltd.

Date	Particulars		Dr. (₹)	Cr. (₹)
31.3.2014	Employees compensation expenses account	Dr.	48,000	
	Employees stock option outstanding account			48,000
	(Being compensation expenses recognized in respect of the employees 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)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2015	Employees compensation expenses account	Dr.	48,000	
	To Employees 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)			
	Profit and loss account	Dr.	48,000	
	To Employees compensation expenses account			48,000
	(Being expenses transferred to profit and loss account at the end of the year)			
31.3.2016	Employees 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)			

30.6.2016	Bank A/c (600 x ₹ 40)	Dr.	24,000	
	Employee stock option outstanding account (600 x ₹ 120)	Dr.	72,000	
	To Equity share capital account (600 x ₹ 10)			6,000
	To Securities premium account (600 x ₹ 150)			90,000
	(Being 600 employees stock option exercised at an exercise price of ₹ 40 each)			
01.10.2016	Employee stock option outstanding account	Dr.	12,000	
	To General reserve account			12,000
	(Being Employees stock option outstanding A/c transferred to General Reserve A/c, on lapse of 100 options at the end of exercise of option period)			

Working Note:

On 31.3.2016, ABC Ltd. will examine its actual forfeitures and make necessary adjustments, if any to reflect expenses for the number of options that have actually vested. 700 employees 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)

Question 3

Santosh Ltd. granted 500 options to each of its 2,500 employees in 2011 at an exercise price of ₹ 50 when the market price was the same. The contractual life (vesting and exercise period) of the options granted is 6 years with the vesting period and exercise period being 3 years each. The expected life is 5 years and the expected annual forfeitures are estimated at 3 per cent. The fair value per option is arrived at ₹ 15. Actual forfeitures in 2011 were 5 per cent. However at the end of 2011 the management of Santosh Ltd. still expects that the actual forfeitures would average only 3 per cent over the entire vesting period. During 2012 the management revises its estimated average forfeiture rate to 10 per cent per annum over the entire vesting period. Of the 2,500 employees 1,900 employees have completed the 3 year vesting period. 1,000 employees exercise their right to obtain shares vested in them in pursuance of ESOP at the end of 2015 and 500 employees exercise their right at the end of 2016. The rights of the remaining employees expire unexercised at the end of 2016. The face value per share is ₹ 10. Show the necessary journal entries with suitable narrations. Workings should form part of the answer.

Answer

Journal Entries

Year 2011		₹	₹
Employee Compensation Expense A/c	Dr.	57,04,205	
To Employee Stock Options Outstanding A/c			57,04,205
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	57,04,205	
To Employee Compensation Expense A/c			57,04,205
(Being Expenses of the year transferred to P & L A/c)			
Year 2012			
Employee Compensation Expense A/c	Dr.	34,08,295	
To Employee Stock Options Outstanding A/c			34,08,295
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	34,08,295	
To Employee Compensation Expense A/c			34,08,295
(Being Expenses of the year transferred to P & L A/c)			
Year 2013			
Employee Compensation Expense A/c	Dr.	51,37,500	
To Employee Stock Options Outstanding A/c			51,37,500
(Being the compensation expenses recognized in respect of the ESOP)			
Profit and Loss A/c	Dr.	51,37,500	
To Employee Compensation Expense A/c			51,37,500
(Being Expenses of the year transferred to P & L A/c)			
Year 2015			
Bank A/c	Dr.	250,00,000	
Employee Stock Options Outstanding A/c	Dr.	75,00,000	
To Share Capital A/c			50,00,000
To Securities Premium			275,00,000
(Being shares issued to employees against options vested in them in pursuance of the ESOP)			

Year 2016			
Bank A/c	Dr.	125,00,000	
Employee Stock Options Outstanding A/c	Dr.	37,50,000	
To Share Capital A/c			25,00,000
To Securities Premium A/c			137,50,000
(Being shares issued to employees against options vested in them in pursuance of the ESOP)			
Employee Stock Options Outstanding A/c	Dr.	30,00,000	
To General Reserve A/c			30,00,000
(Being the balance standing to the credit of stock options outstanding account, in respect of vested options expired unexercised, transferred to general reserve account)			

Working Notes:

1. Fair value of options recognized as expense in the year 2011

Number of options expected to vest = 500 x 2,500 x .97 x .97x .97 = 11,40,841 options*

Fair value of options expected to vest = 11,40,841 × ₹ 15 = ₹ 171,12,615

One third of fair value recognized as expense = ₹ 171,12,615 / 3 = ₹ 57,04,205

Year 2012	
Fair Value of options revised in the year = 500 × 2500 × 0.90 × 0.90 × 0.90 x ₹15	₹ 136,68,750
Revised cumulative expenses in year 2012 = 136,68,750 $\times\frac{2}{3}$	₹ 91,12,500
Less: Already recognized in year 2011	₹ (57,04,205)
Expenses to be recognized in year 2012	₹ 34,08,295
Year 2013	
Number of options actually vested = 1900 × 500 = 9,50,000	
Fair Value of options actually vested = 9,50,000 x ₹ 15	₹ 1,42,50,000
Less: Expense recognized till year 2013	₹ (91,12,500)
Balance amount to be recognized	₹ 51,37,500

* One can also first calculate the estimated employees in absolute figure and then multiply number of options i.e. 2,500 x 0.97 x 0.97 x 0.97 = 2282 employees (approx..) and then 2282 x 50 = 11,41,000 options and so on.

2. Amount recorded in share capital account and securities premium account upon issue of shares

Particulars	*Year 2015*	*Year 2016*
Number of employees exercising option	1,000	500
Number of shares issued upon exercise of option @ 500 per employee	5,00,000	2,50,000
Exercise price received @ ₹ 50 per share	2,50,00,000	1,25,00,000
Corresponding amount recognized in the 'Employee stock options outstanding A/c' @ ₹ 15 per option	75,00,000	37,50,000
Total consideration	3,25,00,000	1,62,50,000
Amount to be recorded in 'Share capital A/c' @ ₹ 10 per share	50,00,000	25,00,000
Amount to be recorded in 'Securities premium A/c' @ ₹ 55 (i.e. 65 –10) per share	2,75,00,000	1,37,50,000
	3,25,00,000	1,62,50,000

Question 4

On 1st April, 2016, a company offered 100 shares to each of its 500 employees at ₹ 50 per share. The employees are given a month to decide whether or not to accept the offer. The shares issued under the plan (ESPP) shall be subject to lock-in on transfers for three years from grant date. The market price of shares of the company on the grant date is ₹ 60 per share. Due to post-vesting restrictions on transfer, the fair value of shares issued under the plan is estimated at ₹ 56 per share.

On 30th April, 2016, 400 employees accepted the offer and paid ₹ 50 per share purchased. Nominal value of each share is ₹ 10.

Record the issue of shares in the books of the company under the aforesaid plan.

Answer

Fair value of an ESPP = ₹ 56 – ₹ 50 = ₹ 6

Number of shares issued = 400 employees x 100 shares/employee = 40,000 shares

Fair value of ESPP which will be recognized as expenses in the year 2016-2017

= 40,000 shares x ₹ 6 = ₹ 2,40,000

Vesting period = 1 month

Expenses recognized in 2016-2017 = ₹ 2,40,000

Journal Entry

Date	*Particulars*	*Dr. (₹)*	*Cr. (₹)*
30.04.2016	Bank A/c (40,000 shares x ₹ 50) Dr.	20,00,000	
	Employees compensation expense A/c Dr.	2,40,000	
	To Share Capital A/c (40,000 shares x ₹ 10)		4,00,000
	To Securities Premium (40,000 shares x ₹ 46)		18,40,000
	(Being shares issued under ESPP @ ₹ 50)		

Exercise

Question 1

At the beginning of year 1, an enterprise grants 300 options to each of its 1,000 employees. The contractual life (comprising the vesting period and the exercise period) of options granted is 6 years. The other relevant terms of the grant are as below:

Vesting Period	*3 years*
Exercise Period	*3 years*
Expected Life	*5 years*
Exercise Price	*₹ 50*
Market Price	*₹ 50*
Expected forfeitures per year	*3%*

The fair value of options, calculated using an option pricing model, is ₹ 15 per option. Actual forfeitures, during the year 1, are 5 per cent and at the end of year 1, the enterprise still expects that actual forfeitures would average 3 per cent per year over the 3 year vesting period. During the year 2, however, the management decides that the rate of forfeitures is likely to continue to increase, and the expected average forfeiture rate for the entire award is changed to 6 per cent per year. It is also assumed that 840 employees have actually completed 3 years vesting period.

200 employees exercise their right to obtain shares vested in them in pursuance of the ESOP at the end of year 5 and 600 employees exercise their right at the end of year 6. Rights of 40 employees expire unexercised at the end of the contractual life of the option, i.e., at the end of year 6. Face value of one share of the enterprise is ₹ 10.

[Answer: The enterprise estimates the fair value of the options expected to vest at the end of the vesting period as No. of options expected to vest = 300 x 1,000 x 0.97 x 0.97 x 0.97 = 2,73,802 options

Fair value of options expected to vest = 2,73,802 options x ₹ 15 = ₹ 41,07,030

In the first year it recognizes ₹ 41,07,030/3 towards the employee services.

Expense to be recognized in year 2 = ₹ 11,22,740

Expense to be recognized in year 3 = ₹ 12,88,250]

Question 2

Write short note on Stock Appreciation Rights.

Question 3

What are the disclosure requirements in respect of share based payments?

8

Financial Reporting for Financial Institutions

BASIC CONCEPTS

MUTUAL FUNDS

In India, mutual funds are regulated by SEBI (Mutual Funds) Regulations, 1996. According to the SEBI (Mutual Funds) Regulations, 1996, a 'mutual fund' means a fund established in the form of a trust to raise monies through the sale of units to the public under one or more schemes for investing in securities including money market instruments. A mutual fund should be registered with SEBI.

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal.

The money thus collected is invested by the fund manager in different types of securities depending upon the objective of the scheme. These could range from shares to debentures to money market instruments

Types of Mutual Funds

On the basis of Structure- The mutual fund schemes can be classified as open ended and close ended. The open-ended schemes permit entry by subscription or exit by sale of units on a continuous basis. The mutual fund announces daily sale and repurchase prices of units for the purpose. The sale and repurchase prices announced by a mutual fund are based on Net Asset Value (NAV) and hence are called the NAV related prices. The close-ended funds have fixed maturity periods e.g. 5-7 years. These schemes are kept open for subscription only during a specified period at the time of launch of the scheme. To provide liquidity, the units are however listed on stock exchanges.

On the basis of Investors Objectives - In terms of investment objectives, mutual fund schemes can be classified as the growth funds and income funds. The growth funds invest major parts of their corpus in equity instruments and hence are exposed to comparatively higher risks. These schemes are expected to provide higher return in form of dividends and capital appreciation. Income funds invest in fixed income debt instruments, e.g. corporate debentures, Government securities and money market instruments and hence are also called the debt funds. They provide steady flow of comparatively lower return for lower risks.

Mutual funds sell their shares to public and redeem them at current Net Asset Value (NAV) which is calculated as under –

$$\frac{\text{Total market value of all MF holdings - All MF liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. If the NAV is more than the face value (₹ 10), it means your money has appreciated and *vice versa*.

Every mutual fund or the asset management company is required to prepare in respect of each financial year an annual report and annual statement of accounts of the schemes and the fund as specified in Eleventh Schedule.

NON-BANKING FINANCE COMPANY

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act* 1956, engaged in the business of providing loans and advances, acquisition of shares, debentures and other securities, leasing, hire-purchase, insurance business and chit business. The term NBFC does not include any institution whose principal business is that of agriculture activity, industrial activity or sale/purchase/construction of immovable property. For purposes of RBI Directions relating to Acceptance of Public Deposits, non-banking financial company means only the non-banking institution which is a – Loan company, Investment company, Hire purchase finance company, Equipment leasing company and Mutual benefit financial company". No non-banking financial company is allowed to commence or carry on the business of a non-banking financial institution without obtaining a certificate of registration issued by the Reserve Bank of India.

Functions of Non-Banking Financial Companies are similar to banks. However, there are a few differences:

(a) A NBFC cannot accept demand deposits;

(b) Non-Banking Financial Companies do not take part in the payment and settlement system and hence cannot issue cheques to its customers; and

(c) Deposit Insurance and Credit Guarantee Corporation (DICGC) does not insure the NBFC deposits.

"Owned fund" means paid up equity capital, preference shares which are compulsorily convertible into equity, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of asset, excluding reserves created by revaluation of asset, as reduced by accumulated loss balance, book value of intangible assets and deferred revenue expenditure, if any;

Net Owned Fund = Owned Fund – Investments in shares of subsidiaries/ companies in same group/Other NBFC. – Book value of debentures, bonds, outstanding loans and

* *Now Companies Act, 2013.*

advances made to and deposits with subsidiaries and companies in the same group (to the extent such sum exceeds 10% of owned fund).

Revised Regulatory Framework for NBFCs

RBI vide notification no. DNBR (PD)CC.No. 002/03.10.001/2014-15 dated November 10, 2014 has revised the regulatory provisions relating to the functioning of NBFCs (except primary dealers) in India.

The revisions brought through this circular shall be applicable to NBFCs-MFI and registered Core Investment Companies also except wherever in conflict with the provision of Non-Banking Financial Company- Micro Finance Institutions (Reserve Bank) Directions, 2011 and Core Investment Companies (Reserve Bank) Directions, 2011 respectively, in which case the Directions ibid will be followed.

The changes introduced to the regulatory framework are delineated below.

a. Requirement of Minimum NOF of ₹200 lakh

Although the requirement of minimum NOF stands at ₹ 200 lakh, the minimum NOF for companies that were already in existence before April 21, 1999 was retained at ₹ 25 lakh. but the revised regulatory framework has mandated all NBFCs to attain a minimum NOF of ₹ 200 lakh by the end of March 2017, as per the milestones given below:

- ₹ 100 lakh by the end of March 2016
- ₹ 200 lakh by the end of March 2017

b. Deposit Acceptance

As per extant NBFCs Acceptance of Public Deposit (Reserve Bank) Directions, 1998, an unrated Asset Finance Company (AFC) having NOF of ₹ 25 lakh or more, complying with all the prudential norms and maintaining capital adequacy ratio of not less than fifteen per cent, is allowed to accept or renew public deposits not exceeding one and half times of its NOF or up to ₹ 10 crore, whichever is lower. AFCs which are rated and complying with all the prudential regulations are allowed to accept deposits up to 4 times of their NOF.

In order to harmonise the deposit acceptance regulations across all deposit taking NBFCs (NBFCs-D), existing unrated AFCs shall have to get themselves rated by March 31, 2016. Those AFCs that do not get an investment grade rating by March 31, 2016, will not be allowed to renew existing or accept fresh deposits thereafter. Further, it has also been decided to harmonise the limit for acceptance of deposits across the sector by reducing the same for rated AFCs from 4 times to 1.5 times of NOF, with effect from the date of this circular.

c. Systemic Significance

The threshold for defining systemic significance for NBFCs-ND has been revised in the light of the overall increase in the growth of the NBFC sector with asset size of ₹ 500 crore and above as per the last audited balance sheet.

With this revision in the threshold for systemic significance, NBFCs-ND shall be categorized into two broad categories viz.,

i. NBFCs-ND (those with assets of less than ₹ 500 crore) and

ii. BFCs-ND-SI (those with assets of ₹ 500 crore and above).

d. Multiple NBFCs

NBFCs that are part of a corporate group or are floated by a common set of promoters will not be viewed on a standalone basis. The total assets of NBFCs in a group including deposit taking NBFCs, if any, will be aggregated to determine if such consolidation falls within the asset sizes of the above two categories.

e. Prudential Norms

The regulatory approach in respect of NBFCs-ND with an asset size of less than ₹ 500 crore will be as under:

(i) They shall not be subjected to any regulation either prudential or conduct of business regulations if they have not accessed any public funds and do not have a customer interface.

(ii) Those having customer interface will be subjected only to conduct of business regulations if they are not accessing public funds.

(iii) Those accepting public funds will be subjected to limited prudential regulations but not conduct of business regulations if they have no customer interface.

(iv) Where both public funds are accepted and customer interface exist, such companies will be subjected both to limited prudential regulations and conduct of business regulations.

(v) Registration under Section 45 IA of the RBI Act will be mandatory.

All NBFCs-ND with assets of ₹ 500 crore and above, irrespective of whether they have accessed public funds or not, shall comply with prudential regulations as applicable to NBFCs-ND-SI. They shall also comply with conduct of business regulations if customer interface exists.

Prudential Regulations Applicable to NBFCs-ND with Assets less than ₹ 500 crore

NBFCs-ND with asset size of less than ₹ 500 crore are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

Prudential Regulations Applicable to NBFCs-ND-SI (asset of ₹ 500 crore and above) and all NBFCs-D

Tier 1 Capital

All NBFCs-ND which have an asset size of ₹ 500 crore and above, and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016.
- 10% by end of March 2017.

"Tier I Capital" means owned fund as reduced by investment in shares of other non-banking financial companies and in shares, debentures, bonds, outstanding loans and advances including hire purchase and lease finance made to and deposits with subsidiaries and companies in the same group exceeding, in aggregate, ten per cent of the owned fund;

"Tier II capital" includes the following:

(a) preference shares other than those which are compulsorily convertible into equity;

(b) revaluation reserves at discounted rate of fifty five percent;

(c) general provisions and loss reserves to the extent these are not attributable to actual diminution in value or identifiable potential loss in any specific asset and are available to meet unexpected losses, to the extent of one and one fourth percent of risk weighted assets;

(d) hybrid debt capital instruments; and

(e) subordinated debt to the extent the aggregate does not exceed Tier I capital.

Asset Classification

In the interest of harmonisation, the asset classification norms for NBFCs-ND-SI and NBFCs-D are being brought in line with that of banks, in a phased manner, as given below.

<u>Lease Rental and Hire-Purchase Assets shall become NPA:</u>

i. if they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;

ii. if overdue for 6 months for the financial year ending March 31, 2017; and

iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

<u>Assets other than Lease Rental and Hire-Purchase Assets shall become NPA:</u>

i. if they become overdue for 5 months for the financial year ending March 31, 2016;

ii. if overdue for 4 months for the financial year ending March 31, 2017; and

iii. if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, sub-standard asset would mean:

i. an asset that has been classified as NPA for a period not exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;

ii. an asset that has been classified as NPA for a period not exceeding 14 months for the financial year ending March 31, 2017; and

iii. an asset that has been classified as NPA for a period not exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For all loan and hire-purchase and lease assets, doubtful asset would mean:

i. an asset that has remained sub-standard for a period exceeding 16 months (currently 18 months) for the financial year ending March 31, 2016;

ii. an asset that has remained sub-standard for a period exceeding 14 months for the financial year ending March 31, 2017; and

iii. an asset that has remained sub-standard for a period exceeding 12 months for the financial year ending March 31, 2018 and thereafter.

For the existing loans, a one-time adjustment of the repayment schedule, which shall not amount to restructuring will, however, be permitted.

- Income from dividend on shares of corporate bodies and units of mutual funds shall be taken into account on cash basis.
- However, income from dividend on shares of corporate bodies may be taken into account on accrual basis when such dividend has been declared by the corporate body in its annual general meeting and the NBFC's right to receive payment is established. Income from bonds and debentures of corporate bodies and from Government securities/bonds may be taken into account on accrual basis.
- Income on securities of corporate bodies or public sector undertakings, the payment of interest and repayment of principal of which have been guaranteed by Central Government or a State Government may be taken into account on accrual basis.

The assets are classified as:

(a) Standard assets;

(b) Sub-standard assets;

(c) Doubtful assets; and

(d) Loss assets.

Provisioning Requirements

Loss Assets

100% of the outstanding should be provided for.

Doubtful Assets

(a) 100% provision to the extent to which the advance is not covered by the realisable value of the security to which the NBFC has a valid recourse shall be made.

(b) In addition to item (a) above, depending upon the period for which the asset has remained doubtful, provision to the extent of 20% to 50% of the secured portion (i.e. estimated realisable value of the outstanding) shall be made on the following basis:

Period for which the asset has been considered as doubtful	% of provision
Upto one year	20
One to three years	30
More than three years	50

Sub-standard asset

A general provision of 10% of total outstanding shall be made.

Standard Assets

The provision for standard assets for NBFCs-ND-SI and for all NBFCs-D has being increased to 0.40% (at present 0.25%). The compliance to the revised norm will be phased in as given below:

- 0.30% by the end of March 2016
- 0.35% by the end of March 2017
- 0.40% by the end of March 2018

This provision towards standard asset need not be netted from gross advances but shown separately as 'Contingent provision against standard assets' in the Balance Sheet.

MERCHANT BANKERS

Merchant bankers are the specialised agency which manages the capital issues. They are also called the managers to the issue. A merchant banker is an organisation that acts as an intermediary between the issuers and the ultimate purchasers of securities in the primary security market. In addition to managing an issue for a client, the services offered by a merchant banker includes underwriting and providing advice on complex financings arrangements, mergers and acquisitions, and at times direct equity investments in corporations.

STOCK AND COMMODITY MARKET INTERMEDIARIES

A stock broker is a member of a recognised stock exchange(s) and is engaged in buying, selling and dealing in securities. A stock broker can deal in securities only after getting registration with SEBI. A stock broker can function as a proprietorship firm, partnership firm or a corporate. Stock brokers are also eligible to act as underwriters without obtaining a separate registration as an underwriter. He may or may not appoint sub-brokers. A sub-broker is subordinate to main stock broker and acts on behalf of a stock broker as an agent or otherwise, for assisting the investors in buying, selling or dealing in securities through such stock brokers. The stock broker as a principal, is responsible to the investor for his sub-brokers' conduct and acts.

In addition to acting as agents for others, a stockbroker may also trade directly by buying and selling securities as principals. If a stockbroker enters into a contract to buy or sale securities as principal with any person other than another stockbroker, he must secure the consent or authorization from the other party and must disclose in the agreement for buying or selling of securities that he is acting as a principal.

Mutual Funds

Question 1

What do you mean by "Net asset value" (NAV) in case of mutual fund units?

Answer

Mutual funds sell their shares to public and redeem them at current Net Asset Value (NAV) which is calculated as under:

$$\frac{\text{Total market value of all Mutual Fund holdings - All Mutual Fund liabilities}}{\text{Unit size}}$$

The net asset value of a mutual fund scheme is basically the per unit market value of all the assets of the scheme. Simply stated, NAV is the value of the assets of each unit of the scheme, or even simpler value of one unit of the scheme. Thus, if the NAV is more than the face value (₹ 10), it means your money has appreciated and vice versa. NAV also includes dividends, interest accruals and reduction of liabilities and expenses, besides market value of investments. NAV is the value of net assets under a mutual fund scheme. The NAV per unit is NAV of the scheme divided by number of units outstanding. NAV of a scheme keeps on changing with change in market value of portfolio under the scheme.

Question 2

Investors Mutual Fund is registered with SEBI and having its registered office at Pune. The fund is in the process of finalizing the annual statement of accounts of one of its open ended mutual fund schemes. From the information furnished below you are required to prepare a statement showing the movement of unit holders' funds for the financial year ended 31st March, 2017.

	₹ ’000
Opening Balance of net assets	*12,00,000*
Net Income for the year (Audited)	*85,000*
8,50,200 units issued during 2016-2017	*96,500*
7,52,300 units redeemed during 2016-2017	*71,320*
The par value per unit is ₹ 100	

Answer

Statement showing the Movement of Unit Holders’ Funds for the year ended 31st March, 2017

	(₹ ’000)
Opening balance of net assets	12,00,000
Add: Par value of units issued (8,50,200 × ₹ 100)	85,020
Net Income for the year	85,000
Transfer from Reserve/Equalisation fund (Refer working note)	15,390
	13,85,410
Less: Par value of units redeemed (7,52,300 × ₹ 100)	(75,230)
Closing balance of net assets (as on 31st March, 2017)	13,10,180

Working Note:

Particulars	*Issued*	*Redeemed*
Units	8,50,200	7,52,300
	₹ ’ 000	*₹ ’ 000*
Par value	85,020	75,230
Sale proceeds / Redemption value	96,500	71,320
Profit transferred to Reserve / Equalisation Fund	11,480	3,910
Balance in Reserve / Equalisation Fund (Issued & Redeemed)	15,390	

Question 3

On 1.4.2016, a mutual fund scheme had 18 lakh units of face value of ₹ 10 each was outstanding. The scheme earned ₹ 162 lakhs in 2016-2017, out of which ₹ 90 lakhs was earned in the first half of the year. On 30.9.2016, 2 lakh units were sold at a “NAV” of ₹ 70.

Pass Journal entries for sale of units and distribution of dividend at the end of 2016-2017.

Answer

Allocation of Earnings	*Old Unit Holders*	*New Unit Holders*	*Total*
	[18 lakhs units]	*[2 lakhs units]*	
	₹ in lakhs	*₹ in lakhs*	*₹ in lakhs*
First half year (₹ 5 per unit)	90.00	Nil	90.00
Second half year (₹ 3.60 per unit)	64.80	7.20	72.00
	154.80	7.20	162.00
Add: Equalization payment recovered	-	-	10.00
Total available for distribution			172.00
Equalization Payment-₹ 90 lakhs ÷ 18 lakhs = ₹ 5 per unit.			
		Old Unit Holders	New Unit Holders
		₹	₹
Dividend distributed		8.60	8.60
Less: Equalization payment		-	(5.00)
		8.60	3.60

Journal Entries

				(₹ in lakhs)
30.9.2016	Bank A/c	Dr.	150.00	
	To Unit Capital			20.00
	To Reserve			120.00
	To Dividend Equalization			10.00
	(Being the amount received on sale of 2 lakhs unit at a NAV of ₹ 70 per unit)			
31.3.2017	Dividend Equalization	Dr.	10.00	
	To Revenue A/c			10.00
	(Being the amount transferred to Revenue Account)			
30.9.2017	Revenue A/c	Dr.	172.00	
	To Bank			172.00
	(Being the amount distributed among 20 lakhs unit holders @ ₹ 8.60 per unit)			

Question 4

A Mutual Fund raised 100 lakh on April 1, 2017 by issue of 10 lakh units of ₹ 10 per unit. The fund invested in several capital market instruments to build a portfolio of ₹ 90 lakhs. The initial expenses amounted to ₹ 7 lakh. During April, 2017, the fund sold certain securities of cost ₹ 38 lakhs for ₹ 40 lakhs and purchased certain other securities for ₹ 28.20 lakhs. The fund management expenses for the month amounted to ₹ 4.50 lakhs of which ₹ 0.25 lakh was in arrears. The dividend earned was ₹ 1.20 lakhs. 75% of the realized earnings were distributed. The market value of the portfolio on 30.04.2017 was ₹ 101.90 lakh.

Determine NAV per unit.

Answer

	₹ in lakhs	*₹ in lakhs*	
Opening bank balance [₹ (100 – 90 - 7) lakhs]	3.00		
Add: Proceeds from sale of securities	40.00		
Dividend received	1.20	44.20	
Less: Cost of securities	28.20		
Fund management expenses [₹ (4.50–0.25) lakhs]	4.25		
Capital gains distributed [75% of ₹ (40.00 – 38.00) lakhs]	1.50		
Dividends distributed (75% of ₹ 1.20 lakhs)	0.90	(34.85)	
Closing bank balance		9.35	
Closing market value of portfolio		101.90	
		111.25	
Less: Arrears of expenses		(0.25)	
Closing net assets		111.00	
Number of units			10,00,000
Closing Net Assets Value (NAV)			₹ 11.10

Question 5

Ramesh Goyal has invested in three mutual funds. From the details given below, find out effective yield on per annum basis in respect of each of the schemes to Ramesh Goyal upto 31-03-2017.

Mutual Fund	*X*	*Y*	*Z*
Date of Investment	*1-12-2016*	*1-1-2017*	*1-3-2017*

Amount of investment (₹)	*1,00,000*	*2,00,000*	*1,00,000*
NAV at the date of investment (₹)	*10.50*	*10.00*	*10.00*
Dividend received upto 31-3-2017 (₹)	*1,900*	*3,000*	*Nil*
NAV as on 31-3-2017 (₹)	*10.40*	*10.10*	*9.80*

Answer

Calculation of effective yield on per annum basis in respect of three mutual fund schemes of Ramesh Goyal upto 31.03.2017

		X	Y	Z
1	Amount of Investment (₹)	1,00,000	2,00,000	1,00,000
2	Date of investment	1.12.2016	1.1.2017	1.3.2017
3	NAV at the date of investment (₹)	10.50	10.00	10.00
4	No. of units on date of investment [1/3]	9,523.809	20,000	10,000
5	NAV per unit on 31.03.2017 (₹)	10.40	10.10	9.80
6	Total NAV of mutual fund investments on 31.03.2017 [4 x 5]	99,047.61	2,02,000	98,000
7	Increase/ decrease of NAV [6-1]	(952.39)	2,000	(2,000)
8	Dividend received upto 31.3.2017	1,900	3,000	Nil
9	Total yield [7+8]	947.61	5,000	(2,000)
10	Yield % [9/1] x 100	0.95%	2.5%	(2%)
11	Number of days	121	90	31
12	Effective yield p.a. [10/11] x 365 days	2.87%	10.14%	(23.55%)

Question 6

The investment portfolio of a mutual fund scheme includes 5,000 shares of X Ltd. and 4,000 shares of Y Ltd. acquired on 31-12-2015. The cost of X Ltd.'s shares is ₹ 40 while that of Y Ltd.'s shares is ₹ 60. The market value of these shares at the end of 2015-2016 were ₹ 38 and ₹ 64 respectively. On 30-06-2016, shares of both the companies were disposed off realizing ₹ 37 per X Ltd. shares and ₹ 67 per Y Ltd. shares. Show important accounting entries in the books of the fund for the accounting years 2015-2016 and 2016-2017.

Answer

Accounting Entries in the books of fund

			₹	₹
31.12.2015	Investment in X Ltd.'s shares A/c (5,000 x ₹ 40)	Dr.	2,00,000	
	Investment in Y Ltd.'s shares A/c (4,000 x ₹ 60)	Dr.	2,40,000	
	To Bank A/c			4,40,000
	(Being investment made in X Ltd. and Y Ltd.)			
31.3.2016	Revenue A/c [5,000 x ₹ (40-38)]	Dr.	10,000	
	To Provision for Depreciation A/c			10,000
	(Being provision created for the reduction in the value of X Ltd.'s shares)			
31.3.2016	Investment in Y Ltd.'s shares A/c [4,000 x ₹ (64-60)]	Dr.	16,000	
	To Unrealised Appreciation Reserve A/c			16,000
	(Being appreciation in the market value of Y Ltd.'s shares transferred to Unrealised Appreciation Reserve A/c)			
01.04.2016	Unrealised Appreciation Reserve A/c	Dr.	16,000	
	To Investment in Y Ltd.'s shares A/c			16,000
	(Being last year's unrealised appreciation reserve balance reversed at the beginning of the current year)			
30.6.2016	Bank A/c (5,000 x ₹ 37)	Dr.	1,85,000	
	Loss on disposal of Investment A/c	Dr.	15,000	
	To Investment in X Ltd.'s shares A/c (5,000 x ₹ 40)			2,00,000
	(Being shares of X Ltd. disposed off at a loss of ₹ 15,000)			
30.6.2016	Provision for Depreciation A/c	Dr.	10,000	
	Revenue A/c	Dr.	5,000	
	To Loss on disposal of Investment A/c			15,000
	(Being net loss on disposal of X Ltd.'s shares charged to revenue account)			

30.6.2016	Bank A/c (4,000 x ₹ 67) Dr.	2,68,000	
	To Investment in Y Ltd.'s shares A/c (4,000 x ₹ 60)		2,40,000
	To Revenue A/c		28,000
	(Being shares of Y Ltd. disposed off at a profit of ₹ 28,000)		

Question 7

A Mutual Fund has launched a new scheme "All Purpose Scheme". The Mutual Fund's Asset management company wishes to invest 25% of the NAV of the Scheme in an unrated debt instrument of a company Y Ltd. which has been paying above average returns for the past many years. The promoters of the company seek your professional advice in light of the Regulations of SEBI. Will the position change in case the debt instruments of the company Y Ltd., is a rated.

Answer

The Seventh Schedule of SEBI (Mutual funds) Regulations, 1996 states that a mutual fund scheme shall not invest more than 10% of its NAV in unrated debt instruments issued by a single issuer and the total investment in such instruments shall not exceed 25% of the NAV of the scheme. All such investments shall be made with the prior approval of the Board of Trustees and the Board of Asset Management Company. It also states that a mutual fund scheme shall not invest more than 10%* of its NAV in debt instruments issued by a single issuer which are rated not below investment grade by an authorised credit rating agency. Such investment limit may be extended to 12% of the NAV of the scheme with the prior approval of the Board of Trustees and the Board of Asset Management Company.

Accordingly,

(i) If the debts instruments of Y Ltd. unrated then Mutual fund's Asset Management Company (AMC) cannot invest more than 10% of its NAV in it.

(ii) If the debts instruments of Y Ltd are rated, then also, Mutual Fund's AMC cannot invest more than 12% of its NAV in it. Therefore, investment of 25% of its NAV of the scheme in debts instrument of Y Ltd. by Mutual Fund's AMC is not permissible as per the SEBI (Mutual Fund) Regulation 1996.

* Amended as per SEBI (Mutual Fund) (Amendments) Regulations, 2016 w.e.f 12.02.2016

Non- Banking Finance Companies

Question 8

Write short notes on:

(i) "Non-Performing Assets" as per NBFC Prudential Norms (RBI) directions.

(ii) Capital adequacy ratio.

(iii) Earning value (Equity share).

Answer

(i) "Non–Performing Asset" as per NBFC Prudential Norms (RBI) directions means:

(a) an asset, in respect of which, interest has remained overdue for a period of six months or more;

(b) a term loan inclusive of unpaid interest, when the instalment is overdue for a period of six months or more or on which interest amount remained overdue for a period of six months or more;

(c) a demand or call loan, which remained overdue for a period of six months or more from the date of demand or call or on which interest amount remained overdue for a period of six months or more;

(d) a bill which remains overdue for a period of six months or more;

(e) the interest in respect of a debt or the income on receivables under the head 'other current assets' in the nature of short term loans/advances, which facility remained overdue for a period of six months or more;

(f) any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months or more;

Note: The above six months criteria for the assets covered under (a) to (f) is till the financial year ending March 31, 2015. However, in future, these assets (other than Lease Rental and Hire-Purchase Assets) shall become NPA:

(i) if they become overdue for 5 months for the financial year ending March 31, 2016;

(ii) if overdue for 4 months for the financial year ending March 31, 2017; and

(iii) if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

(g) the lease rental and hire purchase instalment, which has become overdue for a period of twelve months or more;

Note: The above twelve months criteria for the assets covered under (g) is till the financial year ending March 31, 2015. However, in future, such lease rental and hire-purchase assets shall become NPA:

(i) if they become overdue for 9 months (currently 12 months) for the financial year ending March 31, 2016;

(ii) if overdue for 6 months for the financial year ending March 31, 2017; and

(iii) if overdue for 3 months for the financial year ending March 31, 2018 and thereafter.

(h) in respect of loans, advances and other credit facilities (including bills purchased and discounted), the balance outstanding under the credit facilities (including accrued interest) made available to the same borrower/beneficiary when any of the above credit facilities becomes non-performing asset:

Provided that in the case of lease and hire purchase transactions, a non-banking financial company may classify each such account on the basis of its record of recovery.

(ii) Non-Banking Financial Companies (NBFC) are required to maintain adequate capital. Every NBFC shall maintain a minimum capital ratio consisting of Tier I and Tier II capital which shall not be less than 12% of its aggregate risk-weighted assets on balance sheet and of risk adjusted value of off-balance sheet items.

The total of Tier II capital, at any point of time, shall not exceed 100% of Tier I capital. Capital adequacy is calculated as under:

$$\frac{\text{Tier I} + \text{Tier II Capital}}{\text{Risk Adjusted Assets}} \times 100$$

NBFCs-ND with asset size of less than ₹ 500 crore, are exempted from the requirement of maintaining CRAR and complying with Credit Concentration Norms.

A leverage ratio of 7 is being introduced for all such NBFCs-ND to link their asset growth with the capital they hold. For this purpose, leverage ratio is defined as Total Outside Liabilities / Owned Funds.

At present, all NBFCs-D and NBFCs-ND-SI are required to have minimum CRAR of 15%. Consequently, Tier 1 capital cannot be less than 7.5%. For Infrastructure Finance Companies (IFCs), however, Tier 1 capital cannot be less than 10%. Similarly, NBFCs primarily engaged in lending against gold jewellery have to maintain a minimum Tier 1 capital of 12% w.e.f. April 01, 2014. However, after revision of Regulatory Framework for NBFCs, all NBFCs-ND-SI and all NBFCs-D, shall maintain minimum Tier 1 Capital of 10% instead of 7.5%. The compliance to the revised Tier 1 capital will be phased in as follows:

- 8.5% by end of March 2016

- 10% by end of March 2017.

The minimum Tier 1 capital requirement for NBFCs primarily engaged in lending against gold jewellery remains unchanged for the present.

(iii) "Earning value" means the value of an equity share computed by taking the average of profits after tax as reduced by the preference dividend and adjusted for extra-ordinary and non-recurring items, for the immediately preceding three years and further divided by the number of equity shares of the investee company and capitalised at the following rate:

(a) in case of predominantly manufacturing company, eight per cent;

(b) in case of predominantly trading company, ten per cent; and

(c) in case of any other company, including non-banking financial company, twelve percent;

Note: If, an investee company is a loss making company, the earning value will be taken at zero.

Question 9

While closing its books of account on 31st March, 2017 a Non-Banking Finance Company has its advances classified as follows:

	₹ in lakhs
Standard assets	*16,800*
Sub-standard assets	*1,340*
Secured portions of doubtful debts:	
– *upto one year*	*320*
– *one year to three years*	*90*
– *more than three years*	*30*
Unsecured portions of doubtful debts	*97*
Loss assets	*48*

Calculate the amount of provision, which must be made against the advances as per

(i) the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016; and

(ii) Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016.

Answer

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company – Non-Systemically Important Non-Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.25	42.00
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			427.00

Calculation of provision required on advances as on 31st March, 2017 as per the Non-Banking Financial Company - Systemically Important Non-Deposit taking Company and Deposit taking Company (Reserve Bank) Directions, 2016

	Amount ₹ in lakhs	*Percentage of provision*	*Provision ₹ in lakhs*
Standard assets	16,800	0.35	58.80
Sub-standard assets	1,340	10	134.00
Secured portions of doubtful debts–			
– upto one year	320	20	64.00
– one year to three years	90	30	27.00
– more than three years	30	50	15.00
Unsecured portions of doubtful debts	97	100	97.00
Loss assets	48	100	48.00
			443.80

Question 10

Samvedan Limited is a non-banking finance company. It accepts public deposit and also deals in hire purchase business. It provides you with the following information regarding major hire purchase deals as on 31-03-2015. Few machines were sold on hire purchase basis. The hire purchase price was set as ₹ 100 lakhs as against the cash price of ₹ 80 lakhs. The amount was payable as ₹ 20 lakhs down payment and balance in 5 equal instalments. The hire vendor collected first instalment as on 31-03-2016, but could not collect the second instalment which *was due on 31-03-2017. The company was finalising accounts for the year ending 31-03-2017. Till 15-05-2017, the date on which the Board of Directors signed the accounts, the second instalment was not collected. Presume IRR to be 10.42%.*

Required :

(i) What should be the principal outstanding on 1-4-2016? Should the company recognize finance charge for the year 2016-2017 as income?

(ii) What should be the net book value of assets as on 31-03-2017 so far Samvedan Ltd. is concerned as per NBFC prudential norms requirement for provisioning?

(iii) What should be the amount of provision to be made as per prudential norms for NBFC laid down by RBI?

Answer

(i) Since, the hire-purchaser paid the first instalment due on 31.3.2015, the notional principal outstanding on 1-4-2016 was ₹ 50.25 lakhs (refer W.N.).

In the year ended 31.03.2017, the instalment due of ₹ 16 lakhs has not been received. However, it was due on 31.3.2017 i.e on the balance sheet date, and therefore, it will be classified as standard asset. Samvedan Ltd. will recognise ₹ 5.24 lakhs as interest income included in that due instalment as this should be treated as finance charge.

(ii) The net book value of the assets as on 31.3.2017

	₹ in lakhs
Overdue instalment	16.00
Instalments not due (₹ 16 lakhs x 3)	48.00
	64.00
Less: Finance charge not matured and hence not credited to Profit and loss account (4.11 + 2.88 + 1.52)	(8.51)
	55.49
Less: Provision as per para 9(2)(i) of NBFC prudential norms (Refer point (iii))	7.49
Net book value of assets for Samvedan Ltd.	48.00

(iii) Amount of Provision

	₹ in lakhs
Overdue instalment	16.00
Instalments not due (₹ 16 lakhs x 3)	48.00
	64.00
Less: Finance charge not matured and hence not credited to Profit and	

loss account (4.11 + 2.88 + 1.52)	(8.51)
	55.49
Less: Depreciated value (cash price less depreciation for two years on SLM @ 20%*)	(48.00)
Provision to be created as per para 9(2)(i) of NBFC prudential norms	7.49

Since, the instalment of ₹ 16 lakhs not paid, was due on 31.3.2017 only, the asset is classified as standard asset. Therefore, no additional provision has been made for it.

Working Note:

It is necessary to segregate the instalments into principal outstanding and interest components by using I.R.R. @ 10.42%. *(₹ in lakhs)*

Time	*Opening outstanding amount (a)*	*Cash flow (b)*	*Interest @ 10.42% (c) = (a x 10.42%)*	*Principal repayment (d) = (b – c)*	*Closing outstanding (e) = (a – d)*
31-3-2015		(60)	-----	---	60.00
31-3-2016	60.00	16	6.25	9.75	50.25
31-3-2017	50.25	16	5.24	10.76	39.49
31-3-2018	39.49	16	4.11	11.89	27.60
31-3-2019	27.60	16	2.88	13.12	14.48
31-3-2020	14.48	16	1.52	14.48	0.00

Question 11

Peoples Financiers Ltd. is an NBFC providing Hire Purchase Solutions for acquiring consumer durables. The following information is extracted from its books for the year ended 31st March, 2017:

Asset Funded	*Interest Overdue but recognized in Profit & loss*		*Net Book Value of Assets outstanding*
	Period Overdue	*Interest Amount*	
		(₹ in crore)	*(₹ in crore)*
LCD Televisions	*Upto 12 months*	*480.00*	*20,123.00*
Washing Machines	*For 24 months*	*102.00*	*2,410.00*
Refrigerators	*For 30 months*	*50.50*	*1,280.00*
Air Conditioners	*For 45 months*	*26.75*	*647.00*

You are required to calculate the amount of provision to be made.

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* As per NBFC prudential norms laid down by the RBI.

Answer

On the basis of the information given, in respect of hire purchase and leased assets, additional provision shall be made as under:

			(₹ in crore)
(a)	Where hire charges are overdue upto 12 months	Nil	-
(b)	Where hire charges are overdue for more than 12 months but upto 24 months	10% of the net book value 10% x 2,410	241
(c)	Where hire charges are overdue for more than 24 months but upto 36 months	40 percent of the net book value 40% x 1,280	512
(d)	Where hire charges or lease rentals are overdue for more than 36 months but upto 48 months	70 percent of the net book value 70% x 647	452.90
		Total	1,205.90

Merchant Bankers

Question 12

For what purposes inspection of records and documents of Merchant Banker is ordered by SEBI?

Answer

SEBI has the right to appoint one or more persons as inspecting authority to undertake inspection of the books of account, records and documents of the merchant banker for any of the following purposes:

(i) To see that books of account are being maintained in the required manner;

(ii) To ensure that provisions of SEBI Act, rules and regulations are complied with;

(iii) To investigate into complaints received from investors, other merchant bankers, or any other person on any matter having a bearing on the activities of merchant banker;

(iv) To investigate suo moto in the interest of securities business or investors' interest into the affairs of merchant bankers.

Question 13

Write short note on Capital adequacy requirements of merchant bankers.

Answer

Capital adequacy requirements have been specified by SEBI under the SEBI (Merchant Bankers) Regulations, 1992. Regulation 7 specifies that the requirement of capital adequacy shall be a net worth of not less than five crore rupees. For the purpose of this regulation, ' Net worth' means the sum of paid-up capital and free reserves of the applicant at the time of making application under sub-regulation (1) of regulation 3.

Stock and Commodity Market Intermediaries

Question 14

Write short note on Books of account required to be maintained by a Stock Broker.

Answer

Every stock broker is required to maintain the following books of account, records and documents as per Rule 15 of the Securities Contracts (Regulation) Rules, 1957 and Regulation 17 of the SEBI (Stock Brokers and Sub-Brokers) Regulations, 1992:

(a) Register of transactions (Sauda book);

(b) Clients ledger;

(c) General ledger;

(d) Journals;

(e) Cash book;

(f) Bank Pass Book;

(g) Documents register, containing, inter alia, particulars of securities received and delivered in physical form and the statement of account and other relating to receipt and delivery of securities provided by the depository participants in respect of dematerialized securities;

(h) Members' contract book showing details of all contracts entered into by him with other members of the stock exchange or counterfoils or duplicates of memos of confirmation issued to such other members;

(i) Counterfoils or duplicates of contract notes issued to clients;

(j) Written consent of clients in respect of contracts entered into as principals;

(k) Margin deposit book;

(l) Register of accounts of sub-brokers;

(m) An agreement with a sub-broker specifying the scope of authority and responsibilities of the stock broker and such sub-brokers.

(n) An agreement with the sub-broker and with the client of sub-broker to establish privities of the contract between the stock broker and the client of the stock broker.

Exercise

Question 1

Write short notes on:

(i) Dividend Equalization for a mutual fund.

(ii) Asset liability management for a NBFC.

(iii) Closing out by a member broker.

(iv) Open ended and close ended schemes of mutual funds.

Question 2

A Mutual Fund raised funds on 01.04.2014 by issuing 10 lakhs units @ 17.50 per unit. Out of this Fund, ₹ 160 lakhs invested in several capital market instruments. The initial expenses amount to ₹ 9 lakhs. During June, 2014, the fund sold certain securities worth ₹ 100 lakhs for ₹ 125 lakhs and it bought certain securities for ₹ 90 lakhs. The Fund Management expenses amount to ₹ 5 lakhs per month. The dividend earned was ₹ 3 lakhs. 80% of the realised earnings were distributed among the unit holders. The market value of the portfolio was ₹ 175 lakhs. Determine Net Asset value (NAV) per unit as on 30.06.2014.

[Answer: Total funds raised by Mutual Fund = ₹ 175 lakhs; Closing Net Assets ₹ 181.60 lakhs; Closing NAV ₹ 18.16].

9

Valuation

BASIC CONCEPTS

CONCEPT OF VALUATION

Valuation means measurement of value in monetary term.

Different measurement bases are:

(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.

(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.

(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.

(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.

Other valuation bases:

Net Realisable Value (NRV): This is same as the Realisable (settlement) value. This is the value (net of expenses) that can be realized by disposing off the assets in an orderly manner. Net selling price or exit values also convey the same meaning.

Economic value: This is same as the present value. The other name of it is value to business.

Replacement (cost) value: This is also same as the current cost.

Recoverable (amount) value: This is the higher of the net selling price and value in use.

Deprival value: This is the lower of the replacement value and recoverable (amount) value.

Liquidation value: This is the value (net of expenses), that a business can expect to realize by disposing of the assets in the event of liquidation. Such a value is usually lower than the NRV or exit value. This is also called break-up value.

Fair value: This is not based on a particular method of valuation. It is the acceptable value based on appropriate method of valuation in context of the situation of valuation. Thus fair value may represent current cost, NRV or present value as the case may be.

Three General Approaches to Valuation are:

1) Cost Approach: e.g. Adjusted Book Value
2) Market Approach: e.g. Comparables
3) Income Approach: e.g. Discounted Cash Flow

VALUATION OF TANGIBLE FIXED ASSETS

Para 9 of AS 10 has stated the components of cost as below:

(a) The cost of an item of fixed asset comprises its purchase price, including import duties and other non-refundable taxes or levies, any trade discounts and rebates are deducted in arriving at the purchase price.

(b) Any directly attributable cost of bringing the asset to its working condition for its intended use;

(c) Administration and other general overhead expenses are usually excluded from the cost of fixed assets because they do not relate to a specific fixed asset.

(d) The expenditure incurred on start-up and commissioning of the project, including the expenditure incurred on test runs and experimental production, is usually capitalised as an indirect element of the construction cost.

(e) If the interval between the date a project is ready to commence commercial production and the date at which commercial production actually begins is prolonged, all expenses incurred during this period are charged to the profit and loss statement.

The same principles that apply to value purchased fixed assets at original cost will apply to self-constructed assets also.

Improvement: Expenditure which increase the future benefits from the existing asset is treated as cost of improvement. This cost of improvement or of any addition or extension which becomes integral part of the existing fixed asset is to be added to the value of the asset.

Revaluation: Revaluation of fixed assets may be made to show the assets at their current costs, particularly in context of the historical cost loosing relevance in inflationary situation. Increase in value of fixed assets is shown as revaluation reserve which is not distributable. The loss on revaluation, however, transferred to profit and loss account.

Government Grants related to specific fixed assets, as per AS 12, can be deducted from the cost of the said assets.

Impairment of assets: When the recoverable amount of an asset falls below its carrying amount, as per AS 28, the carrying amount has to be reduced to the recoverable amount and the loss on impairment should be charged to profit and loss account in addition to the depreciation. If subsequently the recoverable amount rises the reversal, i.e., addition shall be made to the already reduced carrying amount.

VALUATION OF INTANGIBLES (AS 26): Meaning - 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.

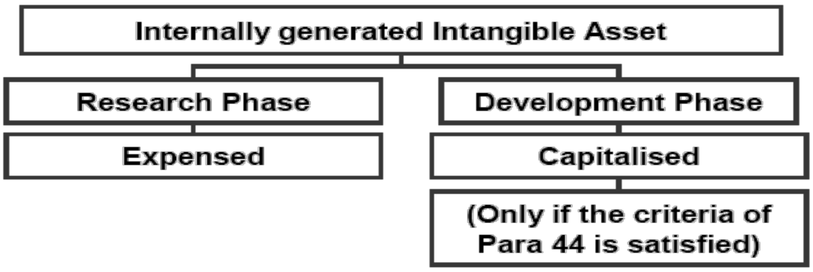
Types- Intangible fixed assets can be classified as **identifiable intangibles and not identifiable intangibles**. The identifiable intangibles include patents, trademarks and designs and brands whereas the not identifiable intangibles are clubbed together as goodwill.

When to Recognize - 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.

If the intangible asset is **internally generated**:



Para 50 of the AS 26 clearly states that 'Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance should not be recognized as intangible assets'.

- For other types of intangible assets Para 41 (AS 26) stated that 'No intangible asset arising from research (or **from the research phase** of an internal project) should be recognised' and
- Para 44 requires that 'An intangible asset arising **from development** (or from the development phase of an internal project) should be recognised if, and only if, all of the conditions specified therein are satisfied'.

When not recognized the expenditure on intangible item would be **treated as expense** and when recognised the expenditure on the intangible item **would be capitalized.**

Subsequent expenditure on an intangible asset after its purchase or its completion should be added to the cost of the intangible asset if:

(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.

Brand Valuation

- **No valuation** shall be made for **internally generated brand**.
- When the **brand is acquired separately**, the valuation would be made **at initial cost of acquisition** (with subsequent addition to cost, if any).

All identifiable intangible assets including Patents, Copyrights, Know-how and Designs which are acquired separately valuation would be made at initial cost of acquisition (with subsequent addition to cost, if any).

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.

Amortization should commence when the asset is available for use.

Valuation of Goodwill – Purchased goodwill can be defined as being the excess of fair value of the purchase consideration over the fair value of the separable net assets acquired. Para 36 of AS-10 Accounting for Fixed Assets' states that only purchased goodwill should be recognised in the accounts.

Goodwill is a thing which is not so easy to describe but in general words good-name, reputation and wide business connection which helps the business to earn more profits than the profit could be earned by a newly started business. The monetary value of the advantage of earning more profits is known as goodwill. Goodwill is an attractive force, which brings in customers to old place of business. Goodwill is an intangible but valuable asset. In a profitable concern it is not a fictitious asset.

Future maintainable profit is ascertained taking either simple or weighted average of the past profits or by fitting trend line. If the past profits do not have any definite trend, average is taken to arrive at the future maintainable profit. If the past profits show increasing or decreasing trend, linear trend equation gives better estimation of the future maintainable profit. If the past profits show increasing or decreasing trend, then more weights are given to the profit figures of the immediate past years and less weight to the profit figures of the furthest past.

The following adjustments from past profits are generally made:

(i) Elimination of abnormal loss arising out of strikes, lock-out, fire, etc. Profit/loss figures which contain abnormal loss should either be ignored or eliminated. Similarly, if there is any abnormal gain included in past profits that needs elimination.

(ii) Interest/dividend or any other income from non-trading assets needs elimination because 'capital employed' used for valuation of goodwill comprises only of trading assets.

(iii) If there is a change in rate of tax, tax charged at the old rate should be added back and tax should be charged at the new rate.

(iv) Effect of change in accounting policies should be neutralised to have profit figures which are arrived at on the basis of uniform policies.

Valuation of Liabilities: The different bases of valuation of liabilities are:

(a) *Historical cost*.

(b) *Current cost*.

(c) *Realisable (settlement) value*. 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*.

The liability items of the balance sheet are generally carried at the settlement values.

Liabilities may be carried at the present value in case of finance lease.

In case of a finance lease, the lessee should recognize a liability equal to the fair value of the leased asset at the inception of the lease.

In regard provision, the valuation is based on settlement value and not on present value.

Valuation of Shares: For transactions concerning relatively small blocks of shares which are quoted on the stock exchange, generally the ruling stock exchange price (average price) provides the basis.

Principally two basic methods are used for share valuation; one on the basis *of net assets* and the other on the basis of *earning capacity* or yield (which, nevertheless, must take into consideration net assets used).

Net Asset Basis: According to this method, value of equity share is determined as follows:

$$\frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}}$$

Yield Basis: Broadly, the following steps are envisaged in a yield based valuation considering the rate of return:

(i) Determination of future maintainable profit;

(ii) Ascertaining the normal rate of return;

(iii) Finding out the capitalization factor or the multiplier;

(iv) Multiplying the future maintainable profit, by the multiplier; and

(v) Dividing the results obtained in (iv) by the number of shares.

The steps necessary to arrive at the future maintainable profits of a company are: (a) calculation of past average taxed earnings, (b) projection of the future maintainable taxed profits, and (c) adjustment of preferred rights.

Mean between asset and yield based valuation: Average of book value and yield based value incorporates the advantages of both the methods. That is why such average is called the fair value of share.

Valuation of Preference Shares: For valuation of preference shares the following factors are generally considered:

(i) Risk free rate plus small risk premium (i.e. market expectation rate).

(ii) Ability of the company to pay dividend on a regular basis.

(iii) Ability of the company to redeem preference share capital.

Ability to pay preference dividend may be judged by using the following ratio:

$$\frac{\text{Profit after tax}}{\text{Preference dividend}}$$

The value of each preference shares can be derived as below:

$$\frac{\text{Preference dividend rate}}{\text{Market expectation rate}} \times 100$$

Valuation of Business: Value of business is different from that of the aggregate value of assets.

Two alternative approaches are available for business valuation: (i) going concern and (ii) liquidation.

The following methods are used for business valuation taking it as a going concern:

(i) Historical cost valuation

(ii) Current cost valuation

(iii) Economic valuation

(iv) Asset valuation.

For piecemeal sale of the business, only 'net realisable value' basis is appropriate.

Historical cost valuation: It is also called book value method. All assets are taken at their respective historical cost. Value of goodwill is ascertained and added to such historical cost of assets.

Historical cost value of business = Historical cost of all assets + Value of goodwill.

Current cost valuation: Current cost of assets is taken for this purpose instead of historical cost.

Economic valuation: Under this method value of the business is given by the sum of discounted value of future earnings or cash flows.

Fair value: NAV on the basis of fair value of assets and liabilities is computed in the same way as computed on the basis of book value except that the fair values of assets and liabilities are considered instead of balance sheet values. The implication of fair value also varies with the objective of valuation, whether the objective is to find the going concern value or the liquidation value.

Earning based valuation of business: Earning based valuation of business = Earning capacity value per share X number of equity shares + Preference share capital + Debt capital. (Book values of preference capital and debt capital should be taken)

Market value model: This is simply the aggregate of the market capitalization and market value of preference capital and debt capital. Market capitalization means market value of equity multiplied by the number of outstanding share. The quoted price of the stock exchanges provides the market value of equity at any moment.

Valuation of Intangibles

Question 1

Discuss methods of valuation of intangible assets in brief.

Answer

Valuation of intangible assets is a complex exercise, as the non-physical form of intangible assets poses the difficulty of identifying the future economic benefits that the enterprise can expect to derive from them. There are three main approaches for valuing intangible assets:

(1) *Cost approach*: In cost approach, historical expenditure incurred in developing the asset is aggregated. Cost is measured by purchase price, where the asset has been acquired recently.

(2) *Market value approach:* In comparable market value approach, intangible assets are valued with reference to transactions involving similar assets that have cropped up recently in similar markets. This approach is possible when there is an active market in which arm's length transactions have occurred recently involving comparable intangible assets and adequate information of terms of transactions is available.

(3) *Economic value approach*: This approach is based on the cash flows or earnings attributable to those assets and the capitalization thereof, at an appropriate discount rate or multiple. Some of the key parameters used in this approach are projected revenues, projected earnings, discount rate, rate of return etc. The information required can be derived from either internal sources, external sources or both. Under this approach, the valuer has to identify cash flows or earnings directly associated with the intangible assets

like the cash flows arising from the exploitation of a patent or copyright, licensing of an intangible asset etc. This approach can be put to practice only if cash flows arising from the intangible assets are identifiable from the management accounts and budgets, forecasts or plans of the company. In most situations of valuation of intangible assets, the economic based approach is used, because of the uniqueness of intangible assets and the lack of comparable market data for the use of market value approach.

Average Capital Employed

Question 2

Find out the average capital employed of ND Ltd. from its summarized Balance Sheet as at 31st March, 2017:

Liabilities	(₹ in lakhs)	Assets	(₹ in lakhs)
Share Capital:		Fixed Assets:	
Equity shares of ₹ 10 each	50.00	Land and buildings	25.00
9% Preference shares fully paid up	10.00	Plant and machinery	80.25
Reserve and Surplus:		Furniture and fixture	5.50
General reserve	12.00	Vehicles	5.00
Profit and Loss	19.50	Investments	10.00
Secured loans:		Inventory	6.75
16% Debentures	5.00	Trade Receivables	4.90
16% Term loan	18.00	Cash and bank	10.40
Cash credit	13.30		
Trade Payables	2.70		
Provision for taxation	6.40		
Proposed dividend on:			
Equity shares	10.00		
Preference shares	0.90		
	147.80		147.80

Non-trade investments were 20% of the total investments.

Balances as on 1.4.2016 to the following accounts were:
Profit and Loss account ₹ 8.20 lakhs, General reserve ₹ 6.50 lakhs.

Answer

Computation of Average Capital employed

		(₹ in lakhs)
Total Assets as per Balance Sheet		147.8
Less: Non-trade investments (20% of ₹ 10 lakhs)		(2.00)
		145.80
Less: Outside Liabilities:		
16% Debentures	5.00	
16% Term Loan	18.00	
Cash Credit	13.30	
Trade Payables	2.70	
Provision for Taxation	6.40	(45.40)
Capital Employed as on 31.03.2017		100.40
Less: ½ of profit earned:		
Increase in Reserve balance	5.50	
Increase in Profit & Loss A/c	11.30	
Proposed Dividend	10.90	
	27.70	
50% of Total		13.85
Average capital employed		86.55

Valuation of Goodwill

Question 3

The following is the extract from the Balance Sheets of Popular Ltd.:

Liabilities	*As at 31.3.2016 ₹ in lakhs*	*As at 31.3.2017 ₹ in lakhs*	*Assets*	*As at 31.3.2016 ₹ in lakhs*	*As at 31.3.2017 ₹ in lakhs*
Share capital	*500*	*500*	*Fixed assets*	*550*	*650*
General reserve	*400*	*425*	*10% Investment*	*250*	*250*
Profit and Loss account	*60*	*90*	*Inventory*	*260*	*300*
18% Term loan	*180*	*165*	*Trade Receivables*	*170*	*110*
Trade Payables	*35*	*45*	*Cash at bank*	*46*	*45*

Provision for tax	*11*	*13*	*Fictitious assets*	*10*	*8*
Proposed dividend	*100*	*125*			
	1,286	*1,363*		*1,286*	*1,363*

Additional information:

(i) Replacement values of fixed assets were ₹ 1,100 lakhs on 31.3.14 and ₹ 1,250 lakhs on 31.3.2017 respectively.

(ii) Rate of depreciation adopted on fixed assets was 5% p.a.

(iii) 50% of the inventory is to be valued at 120% of its book value.

(iv) 50% of investments were trade investments.

(v) Trade Receivables on 31st March, 2017 included foreign trade receivables of \$ 35,000 recorded in the books at ₹ 35 per U.S. Dollar. The closing exchange rate was \$ 1= ₹ 39.

(vi) Trade Payables on 31st March, 2017 included foreign trade payables of \$ 60,000 recorded in the books at \$ 1 = ₹ 33. The closing exchange rate was \$ 1 = ₹ 39.

(vii) Profits for the year 2016-2017 included ₹ 60 lakhs of government subsidy which was not likely to recur.

(viii) ₹ 125 lakhs of Research and Development expenditure was written off to the Profit and Loss Account in the current year. This expenditure was not likely to recur.

(ix) Future maintainable profits (pre-tax) are likely to be higher by 10%.

(x) Tax rate during 2016-2017 was 50%, effective future tax rate will be 40%.

(xi) Normal rate of return expected is 15%.

One of the directors of the company Arvind, fears that the company does not enjoy goodwill in the prevalent market circumstances.

Critically examine this and establish whether Popular Ltd. has or has not any goodwill.

If your answers were positive on the existence of goodwill, show the leverage effect it has on the company's result.

Industry average return was 12% on long-term funds and 15% on equity funds.

Answer

1. *Calculation of Capital employed (CE)*	*₹ in lakhs*	
	As on 31.3.14	*As on 31.3.15*
Replacement Cost of Fixed Assets	1,100.00	1,250.00
Trade Investment (50%)	125.00	125.00

Current cost of inventory		
$130 + 130 \times \frac{120}{100}$	286.00	
$150 + 150 \times \frac{120}{100}$		330.00
Trade Receivables	170.00	111.40
Cash at Bank	46.00	45.00
Total (A)	1,727.00	1,861.40
Less: Outside Liabilities		
18% term loan	180.00	165.00
Trade Payables	35.00	48.60
Provision for tax	11.00	13.00
Total (B)	226.00	226.60
Capital employed (A-B)	1501.00	1634.80

Average Capital employed at current value

$$= \frac{\text{Opening capital employed} + \text{closing capital employed}}{2}$$

$$= \frac{1501 + 1634.80}{2} = 1567.90 \text{ lakhs}$$

2.	*Future Maintainable Profit*	*₹ in lakhs*	
	Increase in General Reserve	25	
	Increase in Profit and Loss Account	30	
	Proposed Dividends	125	
	Profit After Tax	180	
	Pre-tax Profit = $\frac{180}{1-0.5}$		360
	Less: Non-Trading investment income (10% of ₹ 125)	12.50	
	Subsidy	60.00	
	Exchange Loss on Trade Payables [0.6 lakhs × (39-33)]	3.60	

	Additional Depreciation on increase in value of Fixed Assets (current year) $\left(1{,}250 - 650 - 600 \times \frac{5}{100}\right)$ i.e.,	30.00	(106.10)
			253.90
Add:	Exchange Gain on trade receivables [0.35 lakhs × (39-35)]	1.40	
	Research and development expenses written off	125.00	
	Inventory Adjustment (30-26)	4.00	130.40
			384.30
Add:	Expected increase of 10%		38.43
Future Maintainable Profit before Tax			422.73
Less:	Tax @ 40% (40% of ₹ 422.73)		(169.09)
Future Maintainable Profit			253.64

3.	*Valuation of Goodwill*		*₹ in lakhs*
	(i) According to Capitalisation of Future Maintainable Profit Method		
	Capitalised value of Future Maintainable Profit		
	$= \frac{253.64}{15} \times 100$		1,690.93
	Less: Closing capital employed		1,634.80
	Value of Goodwill		56.13
	Or		
	(ii) According to Capitalization of Super Profit Method		
	Future Maintainable Profit		253.64
	Less: Normal Profit @ 15% on average capital employed (1,567.90 ×15%)		235.19
	Super Profit		18.45
	Capitalised value of super profit $\frac{18.45}{15} \times 100$ i.e. Goodwill		123.00

Goodwill exists; hence director's fear is not valid.

Leverage Effect on Goodwill

		₹ in lakhs
Future Maintainable Profit on equity fund		253.64

Future Maintainable Profit on Long-term Trading Capital employed		
Future Maintainable Profit After Tax	253.64	
Add: Interest on Long-term Loan (Term Loan)		
(After considering Tax) 165× 18% = 29.7× $\frac{(100-40)}{100}$	17.82	271.46
Average capital employed (Equity approach)		1,567.90
Add: 18% Term Loan (180+165)/2		172.50
Average capital employed (Long-term Fund approach)		1,740.40
Value of Goodwill		
(A) Equity Approach		
Capitalised value of Future Maintainable Profit = $\frac{253.64}{15} \times 100$ =		1,690.93
Less: Average capital employed		(1,567.90)
Value of Goodwill		123.03
(B) Long-Term Fund Approach		
Capitalized value of Future Maintainable Profit = $\frac{271.46}{12} \times 100$		2262.17
Less: Average capital employed		(1,740.40)
Value of Goodwill		521.77

Comments on Leverage effect of Goodwill: Adverse Leverage effect on goodwill is 398.74 lakhs (i.e., ₹ 521.77 – 123.03). In other words, Leverage Ratio of Popular Ltd. is low for which its goodwill value has been reduced when calculated with reference to equity fund as compared to the value arrived at with reference to long term fund.

Working Notes:

			₹ in lakhs
(1)	Inventory adjustment		
	(i)	Excess current cost of closing inventory over its Historical cost (330 – 300)	30.00
	(ii)	Excess current cost of opening inventory over its Historical cost (286-260)	26.00
	(iii)	Difference [(i– ii)]	4.00
(2)	Trade Receivables' adjustment		
	(i)	Value of foreign exchange Trade Receivables at the closing exchange rate ($35,000×39)	13.65

	(ii)	Value of foreign exchange Trade Receivables at the original exchange rate ($35,000×35)	12.25
	(iii)	Difference [(i) – (ii)]	1.40
(3)	Trade Payables' adjustment		
	(i)	Value of foreign exchange Trade Payables at the closing exchange rate ($ 60,000×39)	23.40
	(ii)	Value of foreign exchange Trade Payables at the original exchange rate($60,000×33)	19.80
	(iii)	Difference [(i) – (ii)]	3.60

Question 4

The summarised Balance Sheet of Domestic Ltd. as on 31st March, 2017 is as under:

Liabilities	*(₹ in lakhs)*	*Assets*	*(₹ in lakhs)*
Equity shares of ₹ 10 each	*3,000*	*Goodwill*	*744*
Reserves (including provision for taxation of ₹ 300 lakhs)	*1,000*	*Premises and Land at cost*	*400*
		Plant and Machinery	*3,000*
5% Debentures	*2,000*	*Motor vehicles (purchased on 1.10.14)*	*40*
Secured loans	*200*	*Raw materials at cost*	*920*
Trade Payables	*300*	*Work-in-progress at cost*	*130*
Profit & Loss A/c:		*Finished goods at cost*	*180*
Balance from previous year 32		*Trade Receivables*	*400*
Profit for the year (after taxation) 1,100	*1,132*	*Investment (meant for replacement of plant and machinery)*	*1,600*
		Cash at bank and cash in hand	*192*
		Discount on debentures	*10*
		Underwriting commission	*16*
	7,632		*7,632*

1. *The resale value of premises and land is ₹ 1,200 lakhs and that of plant and machinery is ₹ 2,400 lakhs.*
2. *Depreciation @ 20% is applicable to motor vehicles.*

3. *Applicable depreciation on premises and land is 2% and that on plant and machinery is 10%.*
4. *Market value of the investments is ₹ 1,500 lakhs.*
5. *10% of trade receivables is bad.*
6. *The company also revealed that the depreciation was not charged to Profit and Loss account and the provision for taxation already made is sufficient.*
7. *In a similar company the market value of equity shares of the same denomination is ₹ 25 per share and in such company dividend is consistently paid during last 5 years @ 25%. Contrary to this, Domestic Ltd. is having a marked upward or downward trend in the case of dividend payment.*
8. *In 2011-2012 and in 2012-2013, the normal business was hampered. The profit earned during 2011-2012 is ₹ 67 lakhs, but during 2012-2013 the company incurred a loss of ₹ 1,305 lakhs.*

   Past 3 years' profits of the company were as under:

2013-2014	₹ 469 lakhs
2014-2015	₹ 546 lakhs
2015-2016	₹ 405 lakhs

   The unusual negative profitability of the company during 2012-2013 was due to the lock out in the major manufacturing unit of the company which happened in the beginning of the second quarter of the year 2011-2012 and continued till the last quarter of 2012-2013.

Value the goodwill of the company on the basis of 4 years' purchase of the super profit.

Answer

1. Rectification of current year's profit i.e. 2016-2017

Profit After Tax = ₹ 1,100 lakhs

Provision for taxation = ₹ 300 lakhs

Profit Before Tax = PAT + Provision for taxation

= ₹ 1,100 lakhs + ₹ 300 lakhs = ₹ 1,400 lakhs

$$\text{Rate of tax} = \frac{\text{Provision for tax}}{\text{Profit before tax}} \times 100 = \frac{300}{1,400} \times 100 = 21.43\% \text{ (approx.)}$$

	₹ in lakhs
Profit for the year after tax	1,100
Less: Depreciation net of tax on motor vehicles (₹ 40 lakhs x 20% x 6/12) x (100-21.43)%	(3.1428)

Depreciation net of tax on Premises and Land (₹ 400 lakhs x 2%) x (100-21.43)%	(6.2856)
Depreciation net of tax on Plant and Machinery (₹ 3,000 lakhs x 10%) x (100-21.43)%	(235.71)
Provision for doubtful receivables net of tax (₹ 400 lakh x 10%) x (100-21.43)%	(31.428)
Rectified profit of 2016-2017	823.43

2. Calculation of Capital Employed

	(₹ in lakhs)	*(₹ in lakhs)*
Premises and land		1,200
Plant and machinery		2,400
Motor vehicles (book value less depreciation for ½ year)		36
Raw materials		920
Work-in-progress		130
Finished goods		180
Trade Receivables (400 x 90%)		360
Investments (market value)		1,500
Cash at bank and in hand		192
		6,918
Less: Liabilities:		
Provision for taxation	300	
5% Debentures	2,000	
Secured loans	200	
Trade Payables	300	(2,800)
Total capital employed on 31.3.2017		4,118
Less: Half of current year's rectified profit (823.43 x 1/2)		(411.72)
Average Capital Employed		3,706.28

3. Calculation of Future Maintainable Profits

				(₹ in lakhs)
	2013-14	2014-15	2015-16	2016-17
Profit after tax	469	546	405	823.43
Less: Depreciation net of tax on Premises and Land (₹ 400 lakhs x 2%) x				

(100-21.43)%	(6.29)	(6.29)	(6.29)	
Depreciation net of tax on Plant and Machinery (₹ 3,000 lakhs x 10%) x (100-21.43)%	(235.71)	(235.71)	(235.71)	
Adjusted Profit	227	304	163	823.43
Average adjusted profit (227+304+163+823.43)/4				379.36
Less: Excess depreciation (net of tax) due to upward revaluation of premises and land [(1,200-400) x 2%] x (100 - 21.43)%				(12.57)
Depreciation on motor vehicle (net of tax) for remaining six months (in future depreciation on motor vehicle will be charged for full year) (₹ 40 lakhs x 20% x 6/12) x (100-21.43)%				(3.14)
Add: Short depreciation (net of tax) due to downward revaluation of plant and machinery [(3,000 - 2,400) x 10%] x (100 - 21.43)%				47.14
Future Maintainable Profit				410.79

4. Calculation of General Expectation

Similar Company pays ₹ 2.5 as dividend (25%) for each share of ₹ 10.

Market value of an equity share of the same denomination is ₹ 25 which fetches dividend of 25%.

Therefore, share of ₹ 10 (Face value of shares of Domestic Ltd.) is expected to fetch (2.5/25) x 100 = 10% return.

A nominal rate of 1% or 2% may be added as Risk premium, to the normal rate of return for uncertainty associated with dividend distribution.

Since, Domestic Ltd. is not having a stable record in payment of dividend, therefore, the expectation from it may be assumed to be slightly higher, say 11% instead of 10%.

5. Calculation of value of goodwill of Domestic Ltd.

	(*₹ in lakhs)*
Future maintainable profit	410.79
Less: Normal profit i.e. 11% of average capital employed (3,706.28x11%)	(407.69)
Super Profit	3.1
Goodwill at 4 years' purchase of Super Profit (3.1 × 4)	12.4

Notes:

(1) It is assumed that 'Provision for Taxation' included in reserves is made in the current year only.

(2) It is assumed that plant and machinery given in the balance sheet is at cost.

(3) It is assumed that depreciation on 'Premises and Land' and 'Plant and Machinery' is charged on Straight Line method.

(4) It is assumed that resale value of 'Premises and Land' and 'Plant and Machinery' given in the question is for depreciated value of respective assets. Therefore, no adjustment for depreciation has been made in such assets while calculating capital employed.

(5) It is assumed that profit for the year 2013-2014, 2014-2015 and 2015-2016 given in the questions is after tax and no depreciation was charged in the earlier years also.

(6) Average Capital employed has been taken for valuation of goodwill.

(7) While considering past profits for determining average profit, the years 2011-2012 and 2012-2013 have been left out, as during these years normal business was hampered.

Question 5

From the following information, determine the possible value of brand as per potential earning model:

		₹ in lakhs
(i)	*Profit After Tax (PAT)*	*2,500*
(ii)	*Tangible fixed assets*	*10,000*
(iii)	*Identifiable intangible other than brand*	*1,500*
(iv)	*Weighted average cost of capital (%)*	*14%*
(v)	*Expected normal return on tangible assets*	
	weighted average cost (14%) + normal spread 4%	*18%*
(vi)	*Appropriate capitalisation factor for intangibles*	*25%*

Answer

Calculation of possible value of brand

	₹ in lakhs
Profit after Tax	2,500
Less: Profit allocated to tangible assets [18% of ₹10,000]	(1,800)
Profit allocated to intangible assets including brand	700

Capitalisation factor 25%	
Capitalised value of intangibles including brand $\left[\frac{700}{25}\times 100\right]$	2,800
Less: Identifiable intangibles other than brand	(1,500)
Brand value	1,300

Question 6

The Balance Sheet of D Ltd. on 31st March, 2017 is as under:

Liabilities	*₹*	*Assets*	*₹*
1,25,000 shares of ₹ 100 each fully paid up	*1,25,00,000*	*Goodwill*	*10,00,000*
		Building	*80,00,000*
Bank overdraft	*46,50,000*	*Machinery*	*70,00,000*
Trade Payables	*52,75,000*	*Inventory*	*80,00,000*
Provision for taxation	*12,75,000*	*Trade receivables (all considered good)*	*50,00,000*
Profit and loss account	*53,00,000*		
	2,90,00,000		*2,90,00,000*

In 2000, when the company started its activities the paid up capital was the same. The Profit/Loss for the last five years is as follows:

2012-2013: Loss (13,75,000), 2013-2014: Profit ₹ 24,55,000, 2014-2015: Profit ₹ 29,25,000, 2015-2016: Profit ₹ 36,25,000, 2016-2017: Profit ₹ 42,50,000.

Income-tax rate so far has been 40% and the above profits have been arrived at on the basis of such tax rate. From 2016-2017, the rate of income-tax should be taken at 45%. 10% dividend in 2013-2014, 2014-2015 and 15% dividend in 2015-2016 and 2016-2017 has been paid. Market price of this share on 31st March, 2017 is ₹ 125. With effect from 1st April, 2017, the Managing Directors remuneration will be ₹ 20,00,000 instead of ₹ 15,00,000. The company has secured a contract from which it can earn an additional ₹ 10,00,000 per annum for the next five years.

Calculate the value of goodwill at 3 years purchase of super profit. (For calculation of future maintainable profits weighted average is to be taken).

Answer

(i) **Future Maintainable Profit**

Year	*Profit (P)* ₹	*Weight (W)*	*Products (PW)* ₹
2013-2014	24,55,000	1	24,55,000
2014-2015	29,25,000	2	58,50,000
2015-2016	36,25,000	3	1,08,75,000
2016-2017	42,50,000	4	1,70,00,000
		10	3,61,80,000

Weighted average annual profit (after tax)* $= \frac{3,61,80,000}{10}$ = ₹ 36,18,000	
Weighted average annual profit before tax is 36,18,000 $\times \frac{100}{60}$	60,30,000
Less: Increase in Managing Director's remuneration	(5,00,000)
	55,30,000
Add: Contract advantage	10,00,000
	65,30,000
Less: Tax @ 45%	(29,38,500)
Future maintainable profit	35,91,500

(ii) **Average Capital Employed**

	₹	₹
Assets		
Building		80,00,000
Machinery		70,00,000
Inventory		80,00,000
Trade Receivables		50,00,000
		2,80,00,000
Liabilities		
Bank Overdraft	46,50,000	

* Loss amounting ₹ 13,75,000 for the year 2012-2013 has not been considered in calculation of weighted average profit assuming that the loss was due to abnormal conditions.

** Additional provision for taxation 5% of ₹ 70,83,333 (₹ 42,50,000/60%) has also been created assuming that the necessary rectification is being done in the financial statements for the year 2016-2017.

Trade Payables	52,75,000	
Provision for taxation	12,75,000	
Additional provision for taxation**	3,54,167	(1,15,54,167)
Capital employed at the end of the year		1,64,45,833
Less: ½ profit after tax for the year [(42,50,000-3,54,167)/2]		(19,47,917)
Average capital employed		1,44,97,916

(iii) Normal Profit

Average dividend for the last four years

$$\frac{10+10+15+15}{4} = 12.5$$

Market Price of share =₹ 125

Normal rate of return* $= \frac{12.5}{125} \times 100 = 10\%$

Normal profit 10% of ₹ 1,44,97,916 ₹ 14,49,792

(iv) Valuation of Goodwill

	₹
Future maintainable profit	35,91,500
Less: Normal profit	(14,49,792)
Super Profit	21,41,708
Goodwill at 3 years' purchase of super profits (₹ 21,41,708 x 3)	64,25,124

Question 7

Find out Leverage effect on Goodwill in the following case:

(i)	*Current cost of capital employed*	*₹ 10,40,000*
(ii)	*Profit earned after current cost adjustments*	*₹ 1,72,000*
(iii)	*10% long term loan*	*₹ 4,50,000*
(iv)	*Normal rate of return:*	
	On equity capital employed	*15.6%*
	On long-term capital employed	*13.5%*

* Normal rate of return has been computed by dividend yield method.

Answer

			₹
a	Profit for equity fund after current cost adjustment		1,72,000
b	Profit (as per Long-term fund approach)		
	Profit for equity fund	1,72,000	
	Add: Interest on Long-term loan (4,50,000 x 10%)	45,000	2,17,000
c	Current cost of capital employed (by Equity approach)		10,40,000
d	Capital employed as per Long-term fund approach		
	Current cost of capital employed (by Equity approach)	10,40,000	
	Add: 10% Long term loan	4,50,000	14,90,000
e	Value of Goodwill		
	(A) By Equity Approach		
	Capitalised value of Profit as per equity approach = $\frac{1,72,000}{15.60} \times 100$		11,02,564
	Less: Capital employed as per equity approach		(10,40,000)
	Value of Goodwill		62,564
	(B) By Long-Term Fund Approach		
	Capitalized value of Profit as per Long-term fund approach = $\frac{2,17,000}{13.5} \times 100$		16,07,407
	Less: Capital employed as per Long-term fund approach		(14,90,000)
	Value of Goodwill		1,17,407

Leverage effect on Goodwill:

Adverse Leverage effect on goodwill is ₹ 54,843 (i.e. ₹ 1,17,407 – ₹ 62,564).

Question 8

A Company Q is willing to sell its business. The purchaser has sought professional advice for the valuation of the goodwill of the company. He has the last audited financial statements together with some additional information. Help him to ascertain the correct price for the purpose of purchase:

The extract of the Balance Sheet as on 31-3-2016 is as under:

Liabilities	₹	Assets	₹
Equity Share Capital (shares of ₹ 100 each)	9,50,000	Goodwill	2,75,000
8% Preference Share Capital (shares of ₹ 100 each)	2,25,000	Land & Building	5,45,000
Reserves & Surplus	10,25,500	Plant & Machinery	4,55,000
9% Debentures	5,60,000	Investments in shares	4,85,000
Current Liabilities	3,25,640	Inventories	3,80,000
		Trade Receivables (net)	4,25,620
		Cash & Bank balance	5,20,520
	30,86,140		30,86,140

(1) The purchaser wants to acquire all the equity shares of the company.

(2) The Debentures will be redeemed at a discount of 25% of the value in Balance Sheet and investments in share will be sold at their present market value which is quoted as ₹ 4,95,200. The above will be prior to the purchase of the equity shares.

For the purpose of pricing of Goodwill:

(3) The normal rate of return on net assets for equity shares is 10%.

(4) Profits for the past three years after debenture interest but before Preference Share Dividend have been as under:

31-3-2016	₹ 2,95,000
31-3-2015	₹ 4,99,000
31-3-2014	₹ 3,25,000

(5) Goodwill is valued at three years purchase of the adjusted average super profit.

(6) In the year 2015, 20% of the profit mentioned above was due to non-recurring transaction resulting in increase of profit.

(7) The Land & Building has a current rental value of ₹ 62,400 and 8% return is expected from the property.

(8) On 31-3-2016, 8% of debtors existing on the date had been written as bad and charged to Profit and Loss Account as Provision for Bad debts. The same are now recoverable Tax is applicable at 35%.

(9) A claim of compensation long contingent of ₹ 25,000 has perspired and is to be accounted for.

(10) No Debenture interest shall be payable in future due to its redemption.

Answer

Valuation of goodwill: Super profits method

Particulars	₹	₹
Net trading assets attributable to equity share holders		
As computing in (WN 1)	23,18,506	
Less: Preference share Capital	(2,25,000)	20,93,506
Normal Rate of Return (NRR) to equity share holders		10%
Normal Profit available to equity share holders (a × b)		2,09,351
Future Maintainable Profits (FMP) to equity share holders		
As computed in (WN 3)	3,75,096	
Less: Preference dividend* (8% of 2,25,000)	(18,000)	3,57,096
Super profits to equity share holders		1,47,745
Goodwill (1,47,745 x 3)		4,43,235

*Since, NRR is given as percentage of net assets attributable to equity shareholders, preference share capital and preference share dividend have been deducted from the net assets and future maintainable profit respectively.

Value Per Equity Share

Net Trading Assets attributable to equity shareholders	₹ 20,93,506
Add: Goodwill	₹ 4,43,235
	₹ 25,36,741

Number of Equity Shares = 9,500 shares,

Value per share = $\frac{25,36,741}{9,500}$ = ₹ 267 (approx.)

Working Notes:

1. **Computation of net trading assets**

Particulars	₹	₹
Sundry assets		
i Land & Building (62,400 ÷ 8%)	7,80,000	
ii Plant and Machinery	4,55,000	
iii Inventory	3,80,000	

iv	Trade receivables (4,25,620 ÷ 92%)	4,62,630	
v	Bank balance (given balance 5,20,520 + Sale of investment 4,95,200 - redemption of debentures 5,60,000 × 75%)	5,95,720	26,73,350
Less: Outside liabilities:			
i	Current Liabilities	3,25,640	
ii	Contingent Liability now to be accounted for	25,000	
iii	Tax provision (WN 2)	4,204	(3,54,844)
Net assets			23,18,506

2. **Calculation of tax provision**

	₹
Profit on reversal of provision for bad debts	37,010
Loss on recognizing omitted claim (assuming tax deductible)	(25,000)
Net incremental profit on which tax is payable	12,010
Tax provision 35%	4,204

3. **Computation of future maintainable profit for the year ended on 31st March**

Particulars		*2014*	*2015*	*2016*
Profit after tax		3,25,000	4,99,000	2,95,000
Less:	Non-recurring profits (after tax) (20% of 2015 Profit)	-	(99,800)	-
Less:	Claims not recorded (after tax) [25,000 x (1-35%)]	-	-	(16,250)
Add:	Provision no longer required (net of tax) [4,25,620 × 8/92 × (1-35%)]	-	-	24,057
Adjusted profits after tax		3,25,000	3,99,200	3,02,807

Simple average of the profits (as profits are fluctuating)	3,42,336
Adjustments for items which will not be reflected in future	
Add: Debenture interest (net of tax) [5,60,000 × 9% × (1 – 0.35)]	32,760
Future maintainable profit [for shareholders- both preference and equity)	3,75,096

Assumptions

1. Tax effect has been ignored on profit on sale of investments and discount on redemption of debentures.
2. Assets and liabilities are recorded at realizable value or fair value. In the absence of information, book values are assumed to be fair values.
3. Additional depreciation on revaluation of property is ignored.
4. Profits for past three years given in the question have been assumed as profits after tax.

Valuation of Bonds

Question 9

Agile Limited is a manufacturer-cum-dealer of 'R Tuff' brand of trousers. With passage of time, its brand has been well accepted in the market. The company has been approached by a foreign company engaged in the same trade to enter as partner in its business. Agile, in order to negotiate the deal wants to get its brand valued. The following information based on market research is available:

(i) Garment industry of which Agile is a constituent, is expected to grow by 9% per annum during the next five years. The present market size of the industry is ₹ 7,500 crores.

(ii) There are other brands both national and international in the market. The existence of duplicate brands is unavoidable. The share of such players is estimated to be 63% of the total industry market. The market share of other national brands will increase @ 0.25% year on year basis in the next 5 years. The share of international brands is expected to grow 1.5 times of national brands. But the existence of duplicate brands is to fall by 2.5% over the period of next 5 years, spread equally.

(iii) The expected foreign partner needs the production line of the company to be re-engineered which will lead to an increase in the yield of the company by 3% after one year over the present yield of 10% followed thereafter by further increase of 5% year on year.

Following the market oriented approach, determine the brand value to be used for negotiation with the foreign company, considering the discount factor for 1st five years as 0.909; 0.826; 0.751; 0.683 and 0.621 (Monetary values in crores to be rounded off to nearest 2 decimal places).

Answer

Market Share of Agile Ltd.

Calculation of last year's market share = 100% –63% = 37%

Increase or decrease in market share of other players [0.25+(.25 x 150%)-2.5/5] = 0.125% i.e. increase in others' market share every year over the period of 5 years. Hence, market share of Agile Ltd. is expected to decrease by 0.125% every year over the period of 5 years, from the current level of 37%.

Brand Valuation under Market Approach

Year	*Market Size (₹ in Crores)*	*Market Share of Agile Ltd.*	*Market Share (₹ in Crores)*	*Expected Profit (₹ in Crores)*	*Discount Factor*	*Discounted Cash Flow (₹ in Crores)*
1	7500 x 109% = 8,175	36.875%	3014.53	@ 10% = 301.45	0.909	274.02
2	8,175 x 109% = 8910.75	36.75%	3274.70	@ 13% = 425.71	0.826	351.64
3	8,910.75x 109% = 9712.72	36.625%	3557.28	@18% = 640.31	0.751	480.87
4	9,712.72 x 109% = 10,586.86	36.5%	3864.20	@23% = 888.77	0.683	607.03
5	10,586.86 x 109% = 11,539.68	36.375%	4197.56	@28% = 1,175.32	0.621	729.87
	Brand Value					2,443.43

Brand Value of Agile Ltd. under Market Oriented Approach is ₹ 2,443.43 crores.

Valuation of Shares

Question 10

Write short note on capital market information - P/E ratio, yield ratio and market value/book value of shares.

Answer

Capital market information-P/E ratio, yield ratio and market value/book value of shares: Frequently share prices data are punched with the accounting data to generate new set of information. These are (i) Price Earnings Ratio, (ii) Yield Ratio, (iii) Market Value/Book Value per share.

$$\text{Price - Earnings Ratio (P/E Ratio)} = \frac{\text{Average Share Price}}{\text{EPS}}$$

(Sometimes it is also calculated with reference to closing share price)

$$\text{P/E Ratio} = \frac{\text{Closing Share Price}}{\text{EPS}}$$

It indicates the pay-back period to the investors or prospective investors. The P/E ratio can be interpreted on a comparison with the industry P/E. A low P/E in comparison to the Industry can indicate that there are prospects for growth in share price and hence could be an indicator to buy/hold the shares. A high P/E ratio in comparison to the Industry can be an indicator to sell the shares.

$$\text{Yield} = \frac{\text{Dividend}}{\text{Average Share Price}} \times 100$$

$$\text{or } \frac{\text{Dividend}}{\text{Closing Share Price}} \times 100$$

This ratio indicates return on investment; this may be on average investment or closing investment. Dividend (%) indicates return on paid up value of shares. But yield (%) is the indicator of true return in which share capital is taken at its market value.

$$\frac{\text{Market Value per share}}{\text{Book Value per share}} = \frac{\text{Average Share Price}}{\text{Net Worth/No. of Equity Shares}} \text{ or } \frac{\text{Closing Share Price}}{\text{Net Worth/No. of Equity Shares}}$$

This ratio indicates market response of the shareholders' investment. Undoubtedly, higher the ratio better is the shareholders' position in terms of return and capital gains.

Question 11

From the following data, compute the 'Net Assets' value of each category of equity shares of Smith Ltd.:

Shareholders' funds

10,000 'A' Equity shares of ₹ 100 each, fully paid

10,000 'B' Equity shares of ₹ 100 each, ₹ 80 paid

10,000 'C' Equity shares of ₹ 100 each, ₹ 50 paid

Retained Earnings ₹ 9,00,000

Answer

(i) Computation of Net assets

Worth of net assets is equal to shareholders' fund, i.e.

		₹
Paid up value of 'A' equity shares	10,000 x ₹ 100	10,00,000
Paid up value of 'B' equity shares	10,000 x ₹ 80	8,00,000
Paid up value of 'C' equity shares	10,000 x ₹ 50	5,00,000
Retained earnings		9,00,000
Net assets		32,00,000

(ii) Net asset value of equity share of ₹ 100 paid up

Notional calls of ₹ 20 and ₹ 50 per share on 'B' and 'C' equity shares respectively will make all the 30,000 equity shares fully paid up at ₹ 100 each. In that case,

	₹
Net assets	32,00,000
Add: Notional calls (10,000 x ₹ 20 + 10,000 x ₹ 50)	7,00,000
	39,00,000

Value of each equity share of ₹ 100 fully paid up = ₹ 39,00,000 / 30,000=₹ 130

(iii) Net asset values of each category of equity shares

	₹
Value of 'A' equity shares of ₹ 100 fully paid up	130
Value of 'B' equity shares of ₹ 100 each, out of which ₹ 80 paid up (130-20)	110
Value of 'C' Equity shares of ₹ 100 each, out of which ₹ 50 paid up (130-50)	80

Alternatively value of an equity share may also be calculated as follows:

Total paid-up capital		₹
'A' equity shares (10,000 x ₹ 100)		10,00,000
'B' equity shares (10,000 x ₹ 80)		8,00,000
'C' equity shares (10,000 x ₹ 50)		5,00,000
		23,00,000
Retained earnings		9,00,000
Net assets value of all shares		32,00,000
Value per rupee of paid up capital = $\frac{\text{Net assets value of all shares}}{\text{Paid up capital}}$ =		$\frac{32,00,000}{23,00,000}$ = ₹ 1.391
Therefore,		
Net assets value of ₹ 100 paid up share	₹ 1.391 x 100	₹ 139.10
Net assets value of ₹ 80 paid up share	₹ 1.391 x 80	₹ 111.28
Net assets value of ₹ 50 paid up share	₹ 1.391 x 50	₹ 69.55

Question 12

The summarized Balance Sheet of RNR Limited as on 31.12.2016 is as follows:

Liabilities	*(₹ in lakhs)*	*Assets*	*(₹ in lakhs)*
1,00,000 equity shares of ₹ 10 each fully paid	*10*	*Goodwill*	*5*
		Fixed assets	*15*
1,00,000 equity shares of ₹ 6 each, fully paid up	*6*	*Other tangible assets*	*5*
		Intangible assets (market	*3*

		value)	
Reserves and Surplus	2		
Liabilities	10		
	28		28

Fixed assets are worth ₹ 24 lakhs. Other Tangible assets are revalued at ₹ 3 lakhs. The company is expected to settle the disputed bonus claim of ₹ 1 lakh not provided for in the accounts. Goodwill appearing in the Balance Sheet is purchased goodwill. It is considered reasonable to increase the value of goodwill by an amount equal to average of the book value and a valuation made at 3 years' purchase of average super-profit for the last 4 years.

After tax, profits and dividend rates were as follows:

Year	PAT (₹ in lakhs)	Dividend %
2013	3.0	11%
2014	3.5	12%
2015	4.0	13%
2016	4.1	14%

Normal expectation in the industry to which the company belongs is 10%.

Akbar holds 20,000 equity shares of ₹ 10 each fully paid and 10,000 equity shares of ₹ 6 each, fully paid up. He wants to sell away his holdings.

(i) Determine the break-up value and market value of both kinds of shares.

(ii) What should be the fair value of shares, if controlling interest is being sold?

Answer

(i) Break up value of ₹1 of share capital $= \frac{₹\ 28.98 \text{ lakhs}}{₹\ 16.00 \text{ lakhs}} = ₹\ 1.81$

Break up value of ₹ 10 paid up share = ₹1.81 × ₹10 = ₹ 18.10

Break up value of ₹ 6 paid up share = ₹1.81 × ₹6 = ₹ 10.86

Market value of shares:

Average dividend $= \left(\frac{11\% + 12\% + 13\% + 14\%}{4}\right) = 12.5\%$

Market value of ₹ 10 paid up share $= \frac{12.5\%}{10\%} \times 10 = ₹\ 12.50$

Market value of ₹ 6 paid up share $= \frac{12.5\%}{10\%} \times 6 = ₹\ 7.50$

(ii) Break up value of share will remain as before even if the controlling interest is being sold. But the market value of shares will be different as the controlling interest would enable the declaration of dividend upto the limit of disposable profit.

$$\frac{\text{Average Profit}}{\text{Paid up value of shares}} \times 100 = \frac{₹\,3.4 \text{ lakhs}}{₹\,16 \text{ lakhs}} \times 100 = 21.25\%$$

Market value of shares:

For ₹ 10 paid up share = $\frac{21.25\%}{10\%} \times 10 =$ ₹ 21.25

For ₹ 6 paid up share = $\frac{21.25\%}{10\%} \times 6 =$ ₹ 12.75

Fair value of shares = $\frac{\text{Breakup value + Market value}}{2}$

Fair value of ₹ 10 paid up share = $\frac{18.10 + 21.25}{2}$ = ₹ 19.68

Fair value of ₹ 6 paid up share = $\frac{10.86 + 12.75}{2}$ = ₹ 11.81

Working Notes:

(₹ in lakhs)

(a) Calculation of average capital employed

Fixed assets		24.00
Other tangible assets		3.00
Intangible assets		3.00
		30.00
Less: Liabilities	10	
Bonus claim	1	(11.00)
		19.00
Less: ½ of profits [½ (4.1 – Bonus 1.0)]		(1.55)
Average capital employed		17.45

(b) Calculation of super profit

Average profit = ¼ (3 + 3.5 + 4 + 4.1 – Bonus 1.0)	
= ¼ × 13.6	3.400
Less: Normal profit = 10 % of ₹ 17.45 lakh	(1.745)
Super profit	1.655

(c) Calculation of goodwill

3 Years' purchase of average super-profit = 3 × 1.655 = ₹ 4.965 lakhs

Increase in value of goodwill = ½ (book value + 3 years' super profit)

= ½ (5 + 4.965)

= ₹ 4.9825 lakhs

Net assets as revalued including book value of goodwill (19 + 5)	24.00
Add: Increase in goodwill (rounded-off)	4.98
Net assets available for shareholders	28.98

Note: In the above solution, tax effect of disputed bonus and corporate dividend tax has been ignored. Also the increase in value of goodwill has been calculated on the basis of the capital employed (excluding purchased goodwill).

Question 13

The following is the summarized Balance Sheet of N Ltd. as on 31st March, 2017:

Balance Sheet

Liabilities	*₹*	*Assets*	*₹*
4,00,000 Equity shares of ₹ 10 each fully paid	*40,00,000*	*Building*	*24,00,000*
13.5% Redeemable preference shares of ₹ 100 each fully paid	*20,00,000*	*Machinery*	*22,00,000*
		Furniture	*10,00,000*
General Reserve	*10,00,000*	*Vehicles*	*18,00,000*
Profit and Loss Account	*3,20,000*	*Investments*	*16,00,000*
Bank Loan (Secured against fixed assets)	*12,00,000*	*Inventory*	*11,00,000*
Trade Payables	*37,00,000*	*Trade Receivables*	*18,00,000*
		Bank Balance	*3,20,000*
	1,22,20,000		*1,22,20,000*

Further information:

(i) Return on capital employed is 20% in similar businesses.

(ii) Fixed assets are worth 30% more than book value. Inventory is overvalued by ₹ 1,00,000, Trade Receivables are to be reduced by ₹ 20,000. Trade investments, which constitute 10% of the total investment are to be valued at 10% below cost.

(iii) Trade investments were purchased on 1.4.2016. 50% of Non-Trade Investments were purchased on 1.4.2014 and the rest on 1.4.2015. Non-Trade Investments yielded 15% return on cost.

(iv) In 2014-2015 new machinery costing ₹ 2,00,000 was purchased, but wrongly charged to revenue. This amount should be adjusted taking depreciation at 10% on reducing value method.

(v) In 2015-2016 furniture with a book value of ₹ 1,00,000 was sold for ₹ 60,000.

(vi) For calculating goodwill two years purchase of super profits based on simple average profits of last four years are to be considered. Profits of last four years are as under:

2013-2014 ₹ 16,00,000, 2014-2015 ₹ 18,00,000, 2015-2016 ₹ 21,00,000, 2016-2017 ₹ 22,00,000.

(vii) Additional depreciation provision at the rate of 10% on the additional value of Plant and Machinery alone may be considered for arriving at average profit.

Find out the intrinsic value of the equity share. Income-tax and Dividend tax are not to be considered.

Answer

Calculation of intrinsic value of equity shares of N Ltd.

1. Calculation of Goodwill

(i) Capital employed

Fixed Assets	₹	₹
Building	24,00,000	
Machinery (₹ 22,00,000 + ₹ 1,45,800)	23,45,800	
Furniture	10,00,000	
Vehicles	18,00,000	
	75,45,800	
Add: 30% increase	22,63,740	
	98,09,540	
Trade investments (₹ 16,00,000 × 10% × 90%)	1,44,000	
Trade Receivables (₹ 18,00,000 – ₹ 20,000)	17,80,000	
Inventory (₹ 11,00,000 – ₹ 1,00,000)	10,00,000	
Bank balance	3,20,000	1,30,53,540
Less: Outside liabilities		
Bank Loan	12,00,000	
Trade Payables	37,00,000	(49,00,000)
Capital employed		81,53,540

(ii) Future maintainable profit

Calculation of average profit

	2013-2014 ₹	*2014-2015* ₹	*2015-2016* ₹	*2016-2017* ₹
Profit given	16,00,000	18,00,000	21,00,000	22,00,000
Add: Capital expenditure of machinery charged to revenue		2,00,000		
Loss on sale of furniture			40,000	
	16,00,000	20,00,000	21,40,000	22,00,000
Less: Depreciation on machinery		(20,000)	(18,000)	(16,200)
Income from non-trade investments		(1,08,000)	(2,16,000)	(2,16,000)
Reduction in value of inventory				(1,00,000)
Bad debts				(20,000)
Adjusted profit	16,00,000	18,72,000	19,06,000	18,47,800

	₹
Total adjusted profit for four years (2013-2014 to 2016-2017)	72,25,800
Average profit (₹ 72,25,800/4)	18,06,450
Less: Depreciation at 10% on additional value of machinery (22,00,000 + 1,45,800) × 30/100 i.e. ₹ 7,03,740	(70,374)
Adjusted average profit	17,36,076

(iii) Normal Profit: 20% on capital employed i.e. 20% on ₹ 81,53,540 = ₹ 16,30,708

(iv) Super profit: Expected profit – normal profit

₹ 17,36,076 – ₹ 16,30,708 = ₹ 1,05,368

(v) Goodwill: 2 years' purchase of super profit

₹ 1,05,368 × 2 = ₹ 2,10,736

2. Net assets available to equity shareholders

	₹	₹
Goodwill as calculated in 1(v) above		2,10,736
Sundry fixed assets		98,09,540
Trade and Non-trade investments		15,84,000
Trade Receivables		17,80,000
Inventory		10,00,000

Bank balance		3,20,000
		1,47,04,276
Less: Outside liabilities		
Bank loan	12,00,000	
Trade Payables	37,00,000	
		(49,00,000)
Preference share capital		(20,00,000)
Net assets for equity shareholders		78,04,276

3. Valuation of equity shares

$$\text{Value of equity share} = \frac{\text{Net assets available to equity shareholders}}{\text{Number of equity shares}}$$

$$= \frac{₹\ 78,04,276}{4,00,000} = ₹\ 19.51$$

Note:

1. Depreciation on the overall increased value of assets (worth 30% more than book value) has not been considered. Depreciation on the additional value of only plant and machinery has been considered taking depreciation at 10% on reducing value method while calculating average adjusted profit.
2. Loss on sale of furniture has been taken as non-recurring or extraordinary item.
3. It has been assumed that preference dividend has been paid till date.

Question 14

The Capital Structure of XYZ Ltd., on 31st March, 2017 was as follows:

	₹
Equity Capital – 18,000 Shares of ₹ 100 each	*18,00,000*
12% Preference Capital – 5,000 Shares of ₹ 100 each	*5,00,000*
12% Secured Debentures	*5,00,000*
Reserves	*5,00,000*
Profit earned before Interest and Taxes during the year	*7,20,000*
Tax Rate	*40%*
Generally the return on equity shares of this type of Industry is 15%.	

Subject to:

(a) *The profit after tax covers Fixed Interest and Fixed Dividends at least 4 times.*

(b) *The Debt Equity ratio is at least 2;*

(c) *Yield on shares is calculated at 60% of distributed profits and 10% of undistributed profits;*

(d) *The Company has been paying regularly an Equity dividend of 15%.*

(e) *The risk premium for Dividends is generally assumed at 1%.*

Find out the value of Equity shares of the Company.

Answer

Calculation of profit after tax (PAT)	₹	₹
Profit before interest & tax (PBIT)		7,20,000
Less: Debenture interest (₹ 5,00,000 × 12/100)		(60,000)
Profit before tax (PBT)		6,60,000
Less: Tax @ 40%		(2,64,000)
Profit after tax (PAT)		3,96,000
Less: Preference dividend $\left(₹\ 5{,}00{,}000 \times \frac{12}{100}\right)$	60,000	
Equity dividend $\left(₹\ 18{,}00{,}000 \times \frac{15}{100}\right)$	2,70,000	(3,30,000)
Retained earnings (undistributed profit)		66,000

Calculation of Interest and Fixed Dividend Coverage

$$= \frac{\text{PAT + Debenture interest}}{\text{Debenture interest + Preference dividend}} = \frac{₹\ 3{,}96{,}000 + ₹\ 60{,}000}{₹\ 60{,}000 + ₹ 60{,}000} = \frac{₹\ 4{,}56{,}000}{₹\ 1{,}20{,}000} = 3.8 \text{ times}$$

Calculation of Debt Equity Ratio

$$\text{Debt Equity Ratio} = \frac{\text{Debt (long term loans)}}{\text{Equity (shareholders' funds)}}$$

$$= \frac{\text{Debentures}}{\text{Preference share capital + Equity share capital + Reserves}}$$

$$= \frac{₹\ 5{,}00{,}000}{₹\ 5{,}00{,}000 + ₹\ 18{,}00{,}000 + ₹\ 5{,}00{,}000}$$

$$\text{Debt Equity Ratio} = \frac{₹\ 5,00,000}{₹\ 28,00,000} = .179$$

The ratio is less than the prescribed ratio.

Calculation of Yield on Equity Shares

Yield on equity shares is calculated at 60% of distributed profits and 10% of undistributed profits:

60% of distributed profits (60% of ₹ 2,70,000)	1,62,000
10% of undistributed profits (10% of ₹ 66,000)	6,600
	1,68,600

$$\text{Yields on equity shares} = \frac{\text{Yield on shares}}{\text{Equity share capital}} \times 100 = \frac{₹\ 1,68,600}{₹\ 18,00,000} \times 100 = 9.37\%$$

Calculation of Expected Yield on Equity Shares	
Normal return expected	15%
Add: Risk premium for low interest and fixed dividend coverage (3.8 < 4)	1%*
Risk for debt equity ratio not required	Nil**
	16%
Value of an Equity Share	
$= \frac{\text{Actual yield}}{\text{Expected yield}} \times \text{Paid up value of a share} = \frac{9.37}{16} \times 100 = ₹\ 58.56$	

* When interest and fixed dividend coverage is lower than the prescribed norm, the riskiness of equity investors is high. They should claim additional risk premium over and above the normal rate of return.

** The debt equity ratio is lower than the prescribed ratio that means outside funds (Debts) are lower as compared to shareholders' funds. Therefore, the risk is less for equity shareholders. Therefore, no risk premium is required to be added in this case.

Question 15

The following abridged Balance Sheet as at 31st March, 2017 pertains to Glorious Ltd.

Liabilities	*₹ in lakhs*	*Assets*	*₹ in lakhs*
Share Capital:		*Goodwill, at cost*	*420*
180 lakhs Equity shares of ₹ 10 each, fully paid up	*1,800*	*Other Fixed Assets*	*11,166*
		Current Assets	*2,910*
90 lakhs Equity shares of ₹ 10		*Loans and Advances*	*933*

each, ₹ 8 paid up	*720*		
150 lakh Equity shares of ₹ 5 each, fully paid-up	*750*		
Reserves and Surplus	*5,457*		
Secured Loans	*4,500*		
Current Liabilities	*1,242*		
Provisions	*960*		
	15,429		*15,429*

You are required to calculate the following for each one of the three categories of equity shares appearing in the above mentioned Balance Sheet:

(i) Intrinsic value on the basis of book values of Assets and Liabilities including goodwill;

(ii) Value per share on the basis of dividend yield.

Normal rate of dividend in the concerned industry is 15%, whereas Glorious Ltd. has been paying 20% dividend for the last four years and is expected to maintain it in the next few years; and

(iii) Value per share on the basis of EPS.

For the year ended 31st March, 2017 the company has earned ₹ 1,371 lakhs as profit after tax, which can be considered to be normal for the company. Average EPS for a fully paid share of ₹ 10 of a Company in the same industry is ₹ 2.

Answer

(i) Intrinsic value on the basis of book values

	₹ in lakhs	*₹ in lakhs*
Goodwill		420
Other Fixed Assets		11,166
Current Assets		2,910
Loans and Advances		933
		15,429
Less: Secured loans	4,500	
Current liabilities	1,242	
Provisions	960	(6,702)
		8,727
Add: Notional call on 90 lakhs equity shares @ ₹ 2 per share		180
		8,907

Equivalent number of equity shares of ₹ 10 each.

	No. of Equity shares
Fully paid shares of ₹ 10 each	180
Partly-paid shares after notional call	90
Fully paid shares of ₹ 5 each, $\left[\dfrac{150 \text{ lakhs}}{10} \times 5\right]$	75
	345

Value per equivalent share of ₹ 10 each = $\dfrac{8{,}907 \text{ lakhs}}{345 \text{ lakhs}}$ = ₹ 25.82

Hence, intrinsic values of each equity share are as follows:

Value of fully paid share of ₹ 10 = ₹ 25.82 per equity share.

Value of share of ₹ 10, ₹ 8 paid-up = ₹ 25.82 – ₹ 2 = ₹ 23.82 per equity share.

Value of fully paid share of ₹ 5 = $\dfrac{25.82}{2}$ = ₹ 12.91 per equity share.

(ii) Valuation on dividend yield basis:

Value of fully paid share of ₹ 10 = $\dfrac{20}{15} \times 10$ = ₹ 13.33

Value of share of ₹ 10, ₹ 8 paid-up = $\dfrac{20}{15} \times 8$ = ₹ 10.67

Value of fully paid share of ₹ 5 = $\dfrac{20}{15} \times 5$ = ₹ 6.67

(iii) Valuation on the basis of EPS:

Profit after tax = ₹ 1,371 lakhs

Total share capital = ₹ (1,800 + 720 + 750) lakhs = ₹ 3,270 lakhs

Earning per rupee of share capital = $\dfrac{1{,}371 \text{ lakhs}}{3{,}270 \text{ lakhs}}$ = ₹ 0.419

Earning per fully paid share of ₹ 10 = ₹ 0.419 × 10 = ₹ 4.19

Earning per share of ₹ 10 each, ₹ 8 paid-up = ₹ 0.419 × 8 = ₹ 3.35

Earning per share of ₹ 5, fully paid-up = ₹ 0.419 × 5 = ₹ 2.10

Value of fully paid share of ₹ 10 = $\dfrac{4.19}{2} \times 10$ = ₹ 20.95

Value of share of ₹ 10, ₹ 8 paid-up = $\frac{3.35}{2} \times 10 =$ ₹ 16.75

Value of fully paid share of ₹ 5 = $\frac{2.10}{2} \times 10 =$ ₹ 10.50

Question 16

The directors of a public limited company are considering the acquisition of the entire share capital of an existing company X Ltd engaged in a line of business suited to them. The directors feel that acquisition of X will not create any further risk to their business interest.

The following is the summarized Balance Sheet of X Ltd., as at 31st December, 2016:

Liabilities	₹	Assets	₹
Share Capital:		Fixed assets	6,00,000
4,000 equity shares of ₹ 100 each fully paid-up	4,00,000	Current assets: Inventory	2,00,000
General reserve	3,00,000	Trade Receivables	3,40,000
Bank overdraft	2,40,000	Cash and bank balances	1,00,000
Trade Payables	3,00,000		
	12,40,000		12,40,000

X's financial records for the past five years were as under:

	2016 ₹	2015 ₹	2014 ₹	2013 ₹	2012 ₹
Profits	80,000	74,000	70,000	60,000	62,000
Extra-ordinary item(s)	3,500	4,000	(6,000)	(8,000)	(1,000)
	83,500	78,000	64,000	52,000	61,000
Dividends	48,000	40,000	40,000	32,000	32,000
	35,500	38,000	24,000	20,000	29,000

Additional information:

(i) There were no changes in the issued capital of X during this period.

(ii) The estimated values of X Ltd.'s assets on 31.12.2016 are:

	Replacement cost ₹	Realizable value ₹
Fixed assets	8,00,000	5,40,000
Inventory	3,00,000	3,20,000

(iii) It is anticipated that 1% of the Trade Receivables may prove to be difficult to be realized.

(iv) The cost of capital to the acquiring company is 10%.

(v) The current return of an investment of the acquiring company is 10%. Quoted companies with similar businesses and activities as X have a P/E ratio approximating to 8, although these companies tend to be larger than X.

Required:

Estimate the value of the total equity capital of X Ltd., on 31.12.2016 using each of the following bases:

(a) Balance sheet value

(b) Replacement cost

(c) Realizable value

(d) P/E ratio model.

Answer

			₹	₹
(a)	**Balance Sheet Value**			
	Capital		4,00,000	
	Reserve		3,00,000	7,00,000
(b)	**Replacement cost value**			
	Capital		4,00,000	
	Reserve		3,00,000	
	Appreciation:			
	Fixed assets	2,00,000		
	Inventory	1,00,000	3,00,000	10,00,000
(c)	**Realizable value**			
	Capital		4,00,000	
	Reserve		3,00,000	
	Appreciation in inventory		1,20,000	
	Depreciation in fixed assets		(60,000)	
	Book debts (Bad)*		(3,400)	7,56,600

(d) P/E ratio model: Comparable quoted companies have a P/E ratio of 8. X Ltd. is prima facie small company.

* It has been assumed that estimated bad debts would not be relevant for estimating values under bases (a) and (b).

If a P/E ratio of 6 is adopted, the valuation will be 80,000 x 6 = ₹ 4,80,000

If a P/E ratio of 7 were to be adopted, the valuation will be 80,000 x 7 = ₹ 5,60,000

Question 17

P Limited is considering the acquisition of R Limited. The financial data at the time of acquisition being:

	P Limited	*R Limited*
Net profit after tax (₹ in lakhs)	*60*	*12*
Number of shares (lakhs)	*12*	*5*
Earnings per share (₹)	*5*	*2.40*
Market price per share (₹)	*150*	*48*
Price earnings ratio	*30*	*20*

It is expected that the net profit after tax of the two companies would continue to be ₹ 72 lakhs even after the amalgamation.

Explain the effect on EPS of the merged company under each of the following situations:

(i) P Ltd. offers to pay ₹ 60 per share to the shareholders of R Ltd.

(ii) P Ltd. offers to pay ₹ 78 per share to the shareholders of R Ltd.

The amount in both cases is to be paid in the form of shares of P Ltd.

Answer

(i) In this case, P Ltd. offers to pay ₹ 60 per share.

The share exchange ratio would be $\frac{60}{150} = 0.4$

It means, P Ltd. would give 0.4 shares for every one share of R Ltd. In other words, P Ltd. would give 2 shares for 5 shares of R Ltd.

The total number of shares to be issued by P Ltd. to R Ltd.

= 5,00,000 × 0.4 = 2,00,000 shares

or

$5,00,000 \times \frac{2}{5}$ = 2,00,000 shares

Total number of shares of P Ltd. after acquisition of R Ltd.

= 12,00,000 + 2,00,000 = 14,00,000 shares

Calculation of E.P.S. of the amalgamated company

$= \frac{\text{Total Net Profit after Interest and Tax}}{\text{Total Number of shares}} = \frac{72,00,000}{14,00,000} =$ ₹ 5.14 per share

After amalgamation, The EPS of P Ltd., will improve from ₹ 5 to ₹ 5.14 whereas EPS of former shareholders of R Ltd would reduce from present 2.40 per share to 5.14 × 0.4 = ₹ 2.056 per share after merger.

(ii) In this case, P Ltd. offers ₹ 78 per share to the shareholders of R Ltd.

The Exchange Ratio would be $\frac{78}{150}$ = 0.52 shares of P Ltd. for each share of R Ltd. In other words, P Ltd would give 52 shares for per 100 shares of R Ltd.

P Ltd would issue 5,00,000 × 0.52 = 2,60,000 shares to shareholders of R Ltd.

E.P.S. of the Merged Company = $\frac{72,00,000}{12,00,000 + 2,60,000} = 4.93$

After Merger, there is a dilution in the E.P.S., of P Ltd. from 5 to 4.93.

After Merger E.P.S. of former shareholders of R Ltd.

= 4.93 × 0.52 = 2.56

There is a gain of ₹ 0.16 in E.P.S. of merged company in comparison to E.P.S. of R Ltd. of ₹ 2.40 before merger.

Comments: Initial increase in and decrease in earnings per share are possible in both cases of Merger. Generally, the dilution in E.P.S. will occur wherever the Price Earnings ratio of acquired company calculated on the basis of price paid exceed the P/E ratio of acquirer company and vice-versa.

In Situation (i) - The price offered by P Ltd. per share of R Ltd. is ₹ 60 and E.P.S. of R Ltd. is 2.4, which would become the earnings of P Ltd. after merger.

Price Earning (P/E) Ratio of P Ltd. after merger = $\frac{60}{2.40} = 25$. It is lower than the P/E Ratio of P Ltd. before merger i.e., 30, the E.P.S. of P Ltd. after merger increases to ₹ 5.14.

In Situation (ii) -The price earnings (P/E) ratio offered for Merger is $\frac{78}{2.4} = 32.5$ which is higher than P/E Ratio of P Ltd. before Merger. Hence, the E.P.S. of P Ltd after merger would get diluted.

Question 18

The following is the Balance Sheet of Bat Ltd. as on 31st March 2017:

Liabilities	₹	Assets	₹
3,00,000 Equity Shares of ₹ 10 each fully paid	30,00,000	Building	20,00,000
12.5% Redeemable preference shares of ₹ 100 each fully paid	20,00,000	Plant & Machinery	22,00,000
General Reserve	11,00,000	Furniture	10,00,000
Profit & Loss A/c	3,00,000	Investments	16,00,000
Secured Loan	10,00,000	Inventory	12,00,000
Trade Payables	30,00,000	Trade Receivables	20,00,000
		Bank Balance	4,00,000
	1,04,00,000		1,04,00,000

Additional Information:

(i) *Fixed assets are worth 20% more than book value. Inventory is overvalued by ₹ 1,00,000. Trade Receivables are to be reduced by ₹ 40,000. Trade investments, which constitute 10% of the total investment are to be valued at 10% below cost.*

(ii) *Trade investments were purchased on 1.4.2016. 50% of non-trade investments were purchased on 1.4.2015 and the rest on 1.4.2016. Non-trade investments yielded 15% return on cost.*

(iii) *In 2015-2016, Furniture with a book value of ₹ 1,00,000 was sold for ₹ 50,000. This loss should be treated as non-recurring or extraordinary item for the purpose of calculating adjusted average profit.*

(iv) *In 2014-2015, new machinery costing ₹ 2,00,000 was purchased, but wrongly charged to revenue. This amount should be adjusted taking depreciation at 10% on reducing value method.*

(v) *Return on capital employed is 20% in similar business.*

(vi) *Goodwill is to be valued at two years purchase of super profits based on simple average profits of last four years.*

Profit of last four years are as under:

Year	Amount (₹)
2013-2014	13,00,000
2014-2015	14,00,000
2015-2016	16,00,000
2016-2017	18,00,000

(vii) It is assumed that preference dividend has been paid till date.

(viii) Depreciation on the overall increased value of assets (worth 20% more than book value) need not be considered. Depreciation on the additional value of only plant and machinery to be considered taking depreciation at 10% on reducing value method while calculating average adjusted profit.

Find out the intrinsic value of the equity share. Ignore income tax and dividend tax.

Answer

Calculation of Intrinsic Value of Equity Shares of Bat Ltd.

Net Assets available for Equity Shareholders.

		₹	₹
Goodwill (W.N.1)			4,14,484
Sundry fixed assets			64,14,960
Trade and non-trade investments (1,44,000+14,40,000)			15,84,000
Trade Receivables			19,60,000
Inventory			11,00,000
Bank balance			4,00,000
Total Assets			1,18,73,444
Less: Outside liabilities			
Secured loan	10,00,000		
Trade Payables	30,00,000	40,00,000	
Preference share capital		20,00,000	(60,00,000)
Net assets available for equity shareholders			58,73,444

$$\text{Value of an equity share} = \frac{\text{Net Assets Available to Equity Shareholders}}{\text{Number of Equity Shares}}$$

$$= \frac{₹\ 58,73,444}{3,00,000} = ₹\ 19.59 \text{ (approx.)}$$

Working Notes:

1. Calculation of Goodwill

(i) Capital Employed

	₹	₹
Fixed assets:		
Building	20,00,000	

Plant and machinery (₹ 22,00,000 + ₹ 1,45,800)	23,45,800	
Furniture	10,00,000	
	53,45,800	
Add: 20% Appreciation	10,69,160	
	64,14,960	
Trade investments (₹ 16,00,000 x 10% x 90%)	1,44,000	
Trade Receivables (₹ 20,00,000 – ₹ 40,000)	19,60,000	
Inventory (₹ 12,00,000 – ₹ 1,00,000)	11,00,000	
Bank Balance	4,00,000	1,00,18,960
Less: Outside liabilities:		
Secured Loan	10,00,000	
Trade Payables	30,00,000	(40,00,000)
Capital employed		60,18,960

(ii) Future Maintainable Profit

Calculation of Average Adjusted Profit

	2013-2014 ₹	*2014-2015* ₹	*2015-2016* ₹	*2016-2017* ₹
Profit	13,00,000	14,00,000	16,00,000	18,00,000
Add: Capital expenditure on Machinery charged to revenue	-	2,00,000	-	-
Loss on sale of furniture		-	50,000	-
	13,00,000	16,00,000	16,50,000	18,00,000
Less: Depreciation on machinery	-	(20,000)	(18,000)	(16,200)
Income from non-trade investments (W.N.2)			(1,08,000)	(2,16,000)
Reduction in the value of inventory	-	-	-	(1,00,000)
Bad debts	-	-	-	(40,000)
Adjusted Profit	13,00,000	15,80,000	15,24,000	14,27,800
Total adjusted profit for four years				58,31,800
Average profit (₹ 58,31,800/4)				14,57,950
Less: Depreciation at 10% on Additional Value of Machinery				
(22,00,000 + 1,45,800) x20%x10%				(46,916)
Average Adjusted Profit				14,11,034

(iii) Normal Profit @ 20% on Capital Employed,

i.e. 20% on ₹ 60,18,960 = ₹ 12,03,792

(iv) Super Profit = Average Adjusted profit–Normal profit

= ₹ 14,11,034 – ₹ 12,03,792=₹ 2,07,242

(v) Goodwill

= 2 years' purchase of super profit = ₹ 2,07,242 x 2 = ₹ 4,14,484

2. Trade investments = ₹ 16,00,000 x 10% x 90% = ₹ 1,44,000

Non-trade investment = ₹ 16,00,000 - ₹ 1,60,000 = ₹ 14,40,000

Non-trade investment purchased on 1.4.2010 = 50% of ₹ 14,40,000 = ₹ 7,20,000

Non-trade investment purchased on 1.4.2011 = ₹ 14,40,000 – ₹ 7,20,000 = ₹ 7,20,000

Income from non-trade investment:

In the year 2015-2016 : 7,20,000 x 15% = ₹ 1,08,000

In the year 2016-2017 : 7,20,000 x 15% = ₹ 1,08,000

7,20,000 x 15% = ₹ 1,08,000

₹ 2,16,000

Question 19

The Balance Sheet of Mulyan Ltd. as on 31st December, 2016 is as follows:

Liabilities	*₹*	*₹*	*Assets*	*₹*
Share Capital:				
Equity shares of ₹ 10 each	*5,00,000*		*Fixed Assets:*	
less, calls in arrear (₹ 2 for final call)	*10,000*	*4,90,000*	*Machinery*	*2,30,000*
			Factory shed	*3,00,000*
8% Preference shares of ₹ 10 each fully paid		*2,00,000*	*Vehicles*	*60,000*
			Furniture	*25,000*
Reserve and Surplus:			*Investments*	*1,00,000*
General Reserve		*1,50,000*	*Current Assets:*	
Profit & Loss A/c		*1,40,000*	*Inventory*	*2,10,000*
Current Liabilities:			*Trade Receivables*	*3,50,000*
Trade Payables		*2,70,000*	*Cash at bank*	*75,000*
Bank Loan		*1,00,000*		
		14,00,000		*14,00,000*

Additional Information:

(i) Fixed assets are worth 20% above their actual book value, depreciation on appreciated portion of fixed assets is to be ignored for valuation of goodwill.

(ii) Of the investments, 80%, is non-trading and the Balance is trading. All trade investments are to be valued at 20% below cost. A uniform rate of dividend of 10% is earned on all investments.

(iii) For the purpose of valuation of shares, Goodwill is to be considered on the basis of 6 year's purchase of the super profits based on simple average profit of the last 3 years. Profits after tax @ 50%, are as follows:

Year	*₹*
2014	*1,90,000*
2015	*2,00,000*
2016	*2,50,000*

(iv) In a similar business, return on capital employed is 20%. In 2014, a new furniture costing ₹ 10,000 was purchased but wrongly charged to revenue. No effect has yet been given for rectifying the same. Depreciation is charged on furniture @ 10% p.a. (Diminishing Balance Method).

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

Answer

Valuation of an equity share

$$\text{Value of an equity share} = \frac{\text{Net assets available to equity shareholders (W.N. 6)}}{\text{Number of equity shares}}$$

$$= 9,47,746 / 50,000 = ₹\ 18.95492$$

Value of a ₹ 10 fully paid up share = ₹ 18.95492 per share

Value of ₹ 10 share, ₹ 8 per share paid up = (₹ 18.95492 – ₹ 2) per share

= ₹ 16.95492 per share

Working Notes:

1. Capital employed

	₹	₹
Fixed Assets:		
Machinery	2,30,000	
Factory shed	3,00,000	
Furniture (₹ 25,000 + ₹ 7,290)	32,290	

Vehicles	60,000	
	6,22,290	
Add: 20% increase	1,24,458	
	7,46,748	
Trade investments (₹ 1,00,000 × 20% ×80%)	16,000	
Inventory in trade	2,10,000	
Trade Receivables	3,50,000	
Cash at bank	75,000	13,97,748
Less: Outside liabilities:		
Bank Loan	1,00,000	
Trade Payables	2,70,000	(3,70,000)
Capital employed		10,27,748

2. Calculation of average adjusted profit

	2014 ₹	*2015* ₹	*2016* ₹
Profit after tax	1,90,000	2,00,000	2,50,000
Add: Tax @ 50%	1,90,000	2,00,000	2,50,000
Profit before tax	3,80,000	4,00,000	5,00,000
Add: Capital expenditure on furniture	10,000		
Less: Depreciation on furniture*	(1,000)	(900)	(810)
Income from non-trade investments	(8,000)	(8,000)	(8,000)
	3,81,000	3,91,100	4,91,190
Less: Tax @ 50%	(1,90,500)	(1,95,550)	(2,45,595)
Adjusted profit	1,90,500	1,95,550	2,45,595

	₹
Total adjusted profit for three years (1,90,500 + 1,95,550 + 2,45,595)	6,31,645
Adjusted Average profit (₹ 6,31,645/3)	2,10,548

3. Normal Profit: 20% on capital employed i.e. 20% on ₹ 10,27,748 = ₹ 2,05,550

* Furniture is assumed to be purchased at the beginning of the year and therefore, depreciation is charged for the whole year in 2014.

4. Super profit: Average Adjusted profit – Normal profit

   = ₹ 2,10,548 – ₹ 2,05,550 = ₹ 4,998

5. Goodwill: 6 years' purchase of super profit

   = ₹ 4,998 × 6 = ₹ 29,988

6. Net assets available to equity shareholders

	₹
Capital employed (W.N.1)	10,27,748
Goodwill (W.N.5)	29,998
Add: Non-trade investments	80,000
	11,37,746
Less: Preference share capital	(2,00,000)
	9,37,746
Add: Notional calls received for calls in arrears	10,000
Net assets for equity shareholders	9,47,746

Question 20

From the following information, calculate the value of a share if you want to

(i) buy a small lot of shares;

(ii) buy a controlling interest in the company.

Year	*Profit*	*Capital Employed*	*Dividend*
	(₹)	*(₹)*	*%*
2013	*55,00,000*	*3,43,75,000*	*12*
2014	*1,60,00,000*	*8,00,00,000*	*15*
2015	*2,20,00,000*	*10,00,00,000*	*18*
2016	*2,50,00,000*	*10,00,00,000*	*20*

The market expectation is 12%.

Answer

(i) Buying a small lot of shares: If the purpose of valuation is to provide data base to aid a decision of buying a small (non-controlling) position of the equity of a company, dividend yield method is most appropriate. Dividend rate is rising continuously, weighted average will be more appropriate for calculation of average dividend.

Year	*Rate of dividend*	*Weight*	*Product*
2013	12	1	12
2014	15	2	30

2015	18	3	54
2016	20	4	80
		10	176

Average dividend = $\frac{176}{10}$ = 17.6%

Value of share on the basis of dividend for buying a small lot of shares will be

$$\frac{\text{Average dividend rate}}{\text{Market expectation rate}} \times 100 = \frac{17.6}{12} \times 100 = ₹146.67 \text{ per share.}$$

(ii) Buying a controlling interest in the company: If the purpose of valuation is to provide data base to aid a decision of buying controlling interest in the company, total profit will be relevant to determine the value of shares as the shareholders have capacity to influence the decision of distribution of profit. As the profit is rising, weighted average will be more appropriate for calculation of average profit/yield.

Year	*Yield % (Profit/Capital employed) x 100*	*Weight*	*Product*
2013	16	1	16
2014	20	2	40
2015	22	3	66
2016	25	4	100
		10	222

Average yield = $\frac{222}{10}$ = 22.2%

If controlling interest in the company is being taken over, then the value per share will be

$$= \frac{\text{Average yield rate}}{\text{Market expectation rate}} \times 100 = \frac{22.2}{12} \times 100 = ₹ 185 \text{ per share.}$$

Question 21

The majority shareholders of MSL Limited desire to sell their holdings to Influx Funds. The following information has been provided by MSL Limited: *₹ in lacs*

Particulars	*2014*	*2015*	*2016*
Equity and Liabilities			
12,000 Equity shares of ₹ 100 each	*12.00*	*12.00*	*12.00*
General Reserve	*6.85*	*7.75*	*9.00*

Profit and Loss Account	*2.64*	*5.95*	*8.25*
Current Liabilities	*6.80*	*5.45*	*3.85*
	28.29	*31.15*	*33.10*
Assets			
Tangible Assets	*12.00*	*13.00*	*14.00*
Intangible Assets			
Goodwill	*6.30*	*5.30*	*4.30*
Current Assets			
Inventories	*6.28*	*7.34*	*8.51*
Other Current Assets	*3.71*	*5.51*	*6.29*
	28.29	*31.15*	*33.10*

(i) The valuation of tangible assets has been done by a professional valuer and increase of 10% in year 2013-2014 and 2014-2015 and 12.5% in 2015-2016 is estimated over the given book value.

(ii) The inventories have been valued at ₹ 6.32 lacs as on 31st March 2014, ₹ 8.47 lacs as on 31st March 2015 and ₹ 10.68 lacs as on 31st March, 2016.

(iii) The company has been charging depreciation @ 10% p.a.

(iv) The balance of Profit and Loss account and General Reserve on 1st April, 2013 was ₹ 2.18 lacs and ₹ 4.25 lacs respectively.

(v) Tax rate was 30% in all the years.

(vi) The goodwill shall be revalued based on 4 years purchase of average super profits of last three years.

(vii) The normal expectation in the industry is 10%.

Calculate the fair value of shares of MSL Limited.

Answer

1. Calculation of Capital Employed *₹ in lacs*

	2013-14	*2014-15*	*2015-16*
Tangible assets (Refer W.N.)	13.08	14.17	15.58
Inventories	6.32	8.47	10.68
Other current assets	3.71	5.51	6.29
	23.11	28.15	32.25
Less: Current Liabilities	(6.80)	(5.45)	(3.85)

Net assets / Closing capital employed	16.31	22.70	28.70
Opening capital employed (by net worth method for the year 2013-2014 = 12 + 2.18 + 4.25 = 18.43)	18.43	16.31	22.70
Average capital employed (Opening capital employed + closing capital employed) / 2	17.37	19.51	25.70

2. Calculation of Future Maintainable Profit ₹ *in lacs*

	2013-14	*2014-15*	*2015-16*
Closing balance of Profit and Loss Account as on 31st March	2.64	5.95	8.25
Add back: Transfer to General reserve (in the year 2013-2014 = 6.85 - 4.25 = 2.60)	2.60	0.90	1.25
	5.24	6.85	9.50
Less: Opening Balance	(2.18)	(2.64)	(5.95)
Profit after tax earned during the year	3.06	4.21	3.55
Add back: Tax @ 30%	1.31	1.80	1.52
Profit before tax	4.37	6.01	5.07
Add back: Amortisation of goodwill (see assumption)	-	1.00	1.00
Less: Extra depreciation on upward revaluation	(0.12)	(0.13)	(0.175)
	4.25	6.88	5.895
Add: Upward valuation of closing inventories	0.04	1.13	2.17
Less: Upward valuation of opening inventories	-	(0.04)	(1.13)
	4.29	7.97	6.94
Less: Tax @ 30%	(1.29)	(2.39)	(2.08)
Future Maintainable Profit	3.00	5.58	4.86

3. Calculation of Goodwill ₹ *in lacs*

	2013-14	2014-15	2015-16
Future Maintainable Profit	3.00	5.58	4.86
Less: Normal profit @ 10% of Average capital employed	(1.74)	(1.95)	(2.57)
Super Profit	1.26	3.63	2.29
Average super profit (1.26 + 3.63 + 2.29)/3			2.39
Goodwill (2.39 x 4 years)			9.56

4. **For valuation of shares as per fair value method**

   A. Value of an Equity Share on net assets basis ₹ *in lacs*

Net assets as on 2015-2016 excluding goodwill	28.70
Add: Goodwill	9.56
Total net assets	38.26
Number of equity shares	12,000 shares

Value of an Equity Share on net assets basis = $\frac{38,22,000}{12,000}$ =₹ 318.83

   B. Value of an equity share on yield basis

	₹ *in lacs*
Average Future Maintainable Profit [(3.00 +5.58 +4.86)/3]	4.48
Less: Transfer to General Reserve - Average transfer [(2.60+0.90+1.25)/3]	(1.58)
Profit available to equity shareholders	2.90
Capitalised value of the profit = $\frac{2.90}{10} \times 100$	29.00

Number of Equity Shares = 12,000 shares

Value of an equity share on yield basis $= \frac{29,00,000}{12.000} =$ ₹ 241.67

Fair value of an equity share

$$= \left(\frac{\text{Value of share as per Net assets method} + \text{Value of share as per yield method}}{2}\right)$$

$$= \frac{318.83 + 241.67}{2} = ₹\ 280.25 \text{ per share}$$

Working Note:

Value of Tangible Assets for the purpose of calculation of Capital Employed

	2013-14	*2014-15*	*2015-16*
Tangible asset as per the Balance Sheet	12.00	13.00	14.00
Add: Upward increase in the value of the asset	1.20	1.30	1.75
	13.20	14.30	15.75
Less: Additional depreciation on the increased value of the asset	(0.12)	(0.13)	(0.175)
	13.08	14.17	15.58

Assumption:

1. Original cost of Goodwill is assumed as ₹ 6.30 lacs only. However, this goodwill has no relevance in future. Therefore, it is a non-recurring item. Hence, while computing future maintainable profit the amortisation of goodwill has been reverted back.
2. Since every year transfer to General reserve was made, so we have also made the necessary adjustment while calculating the profit available to equity shareholders. However, from the information given in the question it was clear that no fixed amount has been transferred to General reserve every year. Therefore, in the absence of the information transfer to General Reserve has been taken as an average of transfers of last 3 years.

Note: The solution given above has been done on the assumption that goodwill is calculated on the basis of Average capital employed. If the solution is done on the basis of closing capital employed then the value of goodwill will be ₹ 8.88 lacs and fair value of an equity share will be ₹ 277.42 per share.

Question 22

Following information is given of the two companies for the year ended 31st March, 2017:

Particulars	*Company A ₹ in lakhs*	*Company B ₹ in lakhs*
Equity shares of ₹ 100 each	12.00	15.00
10% Preference shares of ₹ 100 each	9.00	6.00
Profit after tax	4.50	4.50

Assuming market expectation is 15% and 80% of the profits are distributed, what would you pay for the equity shares of the company, if

(i) You are buying in a small lot?

(ii) You are buying controlling interest is the company?

Answer

(i) Buying a small lot of equity shares: If the purpose of valuation is to provide data base to aid a decision of buying a small lot (non-controlling position) of the company, dividend capitalization method is most appropriate. Under this method, value of an equity share will be:

Dividend per share/Market capitalization rate × 100

Company A : (24/15)× 100 = ₹ 160 per eq. share

Company B : (20.80/15) × 100 = ₹ 138.67 per eq. share

(ii) Buying controlling interest in the company: If the purpose of valuation is to provide data base to aid a decision of buying controlling interest in the company, EPS method is most appropriate. Under this method, value of an equity share will be:-

Earnings per share/Market capitalization rate x 100

Company A : (30/15) x 100 = ₹ 200 per eq. share

Company B : (26/15) x 100 = ₹ 173.33 per eq. share

Working Note:

Calculation of dividend

	Company A ₹ in lakhs	*Company B ₹ in lakhs*
Profit after tax	4.50	4.50
Less: Preference dividend	0.90	0.60
	3.60	3.90
No. of shares	12,000	15,000
Earnings for equity share holders	30.00	26.00
Dividend (80%)	24.00	20.80

Valuation of Business

Question 23

Timby Ltd. is in the business of making sports equipment. The Company operates from Thailand. To globalise its operations, Timby has identified Fine Toys Ltd. an Indian Company, as a potential takeover candidate. After due diligence of Fine Toys Ltd. the following information is available:

(a)

Cash Flow Forecasts									*(₹ in crore)*	
Year	*10*	*9*	*8*	*7*	*6*	*5*	*4*	*3*	*2*	*1*
Fine Toys Ltd.	*24*	*21*	*15*	*16*	*15*	*12*	*10*	*8*	*6*	*3*
Timby Ltd.	*108*	*70*	*55*	*60*	*52*	*44*	*32*	*30*	*20*	*16*

(b) The net worth of Fine Toys Ltd. (₹ in lakhs) after considering certain adjustments suggested by the due diligence team reads as under:

Tangible		*750*
Inventories		*145*
Receivables		*75*

		970
Less:		
Trade Payables	*165*	
Bank Loans	*250*	*(415)*
Represented by equity shares of ₹ 1,000 each		*555*

Talks for takeover have crystalized on the following:

1. *Timby Ltd. will not be able to use Machinery worth ₹ 75 lakhs which will be disposed of by them subsequent to take over. The expected realization will be ₹ 50 lakhs.*
2. *The inventories and receivables are agreed for takeover at values of ₹ 100 and ₹ 50 lakhs respectively which is the price they will realize on disposal.*
3. *The liabilities of Fine Toys Ltd. will be discharged in full on take over alongwith an employee settlement of ₹ 90 lakhs for the employees who are not interested in continuing under the new management.*
4. *Timby Ltd. will invest a sum of ₹ 150 lakhs for upgrading the Plant of Fine Toys Ltd. on takeover. A further sum of ₹ 50 lakhs will also be incurred in the second year to revamp the machine shop floor of Fine Toys Ltd.*
5. *The Anticipated Cash Flows (in ₹ crore) post takeover are as follows:*

Year	*1*	*2*	*3*	*4*	*5*	*6*	*7*	*8*	*9*	*10*
Cash Flows	*18*	*24*	*36*	*44*	*60*	*80*	*96*	*100*	*140*	*200*

You are required to advise the management the maximum price which they can pay per share of Fine Toys Ltd. if a discount factor of 20 per cent is considered appropriate.

Answer

Calculation of Maximum Price that can be quoted for takeover of Fine Toys Ltd.

	₹ in lakhs	*₹ in lakhs*
Present (Discounted) value of incremental cash flows (Refer Working Note)		7,845.02
Add: Proceeds from disposal of fixed assets	50.00	
Proceeds from disposal of inventories	100.00	
Receipts from Trade Receivables	50.00	200.00
		8,045.02
Less: Settlement of Trade Payables	165.00	
Bank Loans	250.00	

Employee settlement	90.00	
Renovation of Plant	150.00	
Revamp of machine shop floor (₹ 50 lakhs× 0.6944)*	34.72	(689.72)
Maximum value that can be offered		7,355.30
Maximum price per share of Fine Toys Ltd. (₹ 7,355.30 lakhs / 55,500 shares)		₹ 13,252.79

Working Note:

Present Value of Incremental Cash Flows

(₹ in lakhs)

Year	Cash flow after takeover	Cash flows before takeover	Incremental Cash flows	Discount factor @ 20%	Discounted Cash flows
1	1,800	1600	200	0.8333	166.66
2	2,400	2000	400	0.6944	277.76
3	3,600	3000	600	0.5787	347.22
4	4,400	3200	1200	0.4823	578.76
5	6,000	4400	1600	0.4019	643.04
6	8,000	5200	2800	0.3349	937.72
7	9,600	6000	3600	0.2791	1,004.76
8	10,000	5500	4500	0.2326	1,046.70
9	14,000	7000	7000	0.1938	1,356.60
10	20,000	10800	9200	0.1615	1,485.80
					7,845.02

Question 24

The summarized Balance Sheet of R Ltd. for the year ended on 31st March, 2015, 2016 and 2017 are as follows:

	(₹ in thousands)		
Liabilities	*31.3.2015*	*31.3.2016*	*31.3.2017*
3,20,000 equity shares of ₹ 10 each, fully paid	*3,200*	*3,200*	*3,200*
General reserve	*2,400*	*2,800*	*3,200*
Profit and Loss account	*280*	*320*	*480*
Trade Payables	*1,200*	*1,600*	*2,000*
	7,080	*7,920*	*8,880*

* Discount factor of year 2 @ 20%.

Assets			
Goodwill	*2,000*	*1,600*	*1,200*
Building and Machinery less, depreciation	*2,800*	*3,200*	*3,200*
Inventory	*2,000*	*2,400*	*2,800*
Trade Receivables	*40*	*320*	*880*
Bank balance	*240*	*400*	*800*
	7,080	*7,920*	*8,880*

Additional information:

(a) Actual valuations were as under

Building and machinery less, depreciation	*3,600*	*4,000*	*4,400*
Inventory	*2,400*	*2,800*	*3,200*
Net profit (including opening balance after writing off depreciation, goodwill, tax provision and transferred to general reserve)	*840*	*1,240*	*1,640*

(b) Capital employed in the business at market value at the beginning of 2014-2015 was ₹ 73,20,000 which included the cost of goodwill. The normal annual return on average capital employed in the line of business engaged by R Ltd. is 12½%.

(c) The balance in the general reserve on 1st April, 2014 was ₹ 20 lakhs.

(d) The goodwill shown on 31.3.2015 was purchased on 1.4.2014 for ₹ 20 lakhs on which date the balance in the Profit and Loss account was ₹ 2,40,000. Find out the average capital employed in each year.

(e) Goodwill is to be valued at 5 year's purchase of Super profit (Simple average method). Find out the total value of the business as on 31.3.2017.

Answer

Total value of business	**₹**
Total net Asset as on 31.3.2017	84,80,000
Less: Goodwill as per Balance Sheet	(12,00,000)
Add: Goodwill as calculated in Working Note 2	41,12,500
Value of Business	1,13,92,500

Working Notes:

1. Capital Employed at the end of each year

	31.3.2015 ₹	*31.3.2016* ₹	*31.3.2017* ₹
Goodwill	20,00,000	16,00,000	12,00,000
Building and Machinery (Revaluation)	36,00,000	40,00,000	44,00,000
Inventory (Revalued)	24,00,000	28,00,000	32,00,000
Trade Receivables	40,000	3,20,000	8,80,000
Bank Balance	2,40,000	4,00,000	8,00,000
Total Assets	82,80,000	91,20,000	104,80,000
Less: Trade Payables	(12,00,000)	(16,00,000)	(20,00,000)
Closing Capital	70,80,000	75,20,000	84,80,000
Add: Opening Capital	73,20,000	70,80,000	75,20,000
Total	1,44,00,000	1,46,00,000	1,60,00,000
Average Capital	72,00,000	73,00,000	80,00,000

Since the goodwill has been purchased, it is taken as a part of Capital employed.

2. Valuation of Goodwill

		31.3.2015	31.3.2016	31.3.2017
(i)	**Future Maintainable Profit**			
	Net Profit as given	8,40,000	12,40,000	16,40,000
	Less: Opening Balance	(2,40,000)	(2,80,000)	(3,20,000)
	Adjustment for Valuation of Opening Inventory	-	(4,00,000)	(4,00,000)
	Add: Adjustment for Valuation of closing inventory	4,00,000	4,00,000	4,00,000
	Goodwill written off	-	4,00,000	4,00,000
	Transferred to General Reserve	4,00,000	4,00,000	4,00,000
	Future Maintainable Profit	14,00,000	17,60,000	21,20,000
	Less: 12.50% Normal Return	(9,00,000)	(9,12,500)	(10,00,000)
(ii)	**Super Profit**	5,00,000	8,47,500	11,20,000

(iii) Average Super Profit = ₹ (5,00,000 + 8,47,500+11,20,000) ÷ 3 = ₹ 8,22,500

(iv) Value of Goodwill at five years' purchase= ₹ 8,22,500 × 5 = ₹ 41,12,500.

Question 25

NRPL (Nuclear Reactors Private Limited) is engaged in the business of design and construction of nuclear reactors that are supplied exclusively to the Atomic Energy Department. The core component of such reactors is outsourced by NRPL from FIL (Fusion Industrials Ltd.) the sole manufacturer of this item. NRPL wants to gain leadership in this industry and seeks to take over FIL. NRPL estimates that its Goodwill in the industry will increase by a minimum of ₹ 300 crores consequent on the acquisition. NRPL has made the following calculation of the economic benefits presently available and that foreseen as a result of the acquisition.

(i) Projected Cash Flows of NRPL for the next 5 years:

Year	1	2	3	4	5
Cash flow (₹ in crores)	1,000	1,500	2,000	2,500	3,000

(ii) Projected Cash Flow of FIL for the next 5 years.

Year	1	2	3	4	5
Cash flow (₹ in crores)	400	400	600	800	1,000

(iii) Audited net worth of FIL

	₹ in crores
Fixed assets	2,000
Investments (non-trade)	1,000
Current assets	1,000
Total	4,000
Current liabilities	1,000
Net worth	3,000

(iv) Other information:

(a) 10% of the fixed assets of FIL will not be required in the event of the acquisition and the same has ready buyers for ₹ 100 crore.

(b) Current Assets include surplus inventory of ₹ 20 crore that can realize ₹ 30 crore.

(c) Investments have a ready marked for ₹ 1,500 crore.

(d) The current liabilities are to be paid off immediately; ₹ 510 crores are payable on account of a compensation claim awarded against FIL, which has been treated as a contingent liability in the accounts on which 20 percent was provided for.

(v) NRPL has estimated the combined cash flows post merger as under:

Year	*1*	*2*	*3*	*4*	*5*
Cash flow (₹ in crores)	*1,500*	*2,000*	*2,500*	*3,000*	*3,500*

You are required to advise NRPL the maximum value it can pay for takeover of FIL; also show the current valuation of FIL as a 'Stands Alone' entity. The Discount rate of 15% is advised appropriate, values for which are given below:

Year	*P.V*
1	*0.870*
2	*0.756*
3	*0.658*
4	*0.572*
5	*0.497*

Answer

(1) Calculation of operational synergy expected to arise out of merger

(₹ in crores)

Year	*1*	*2*	*3*	*4*	*5*
Projected cash flows of NRPL after merger with FIL	1,500	2,000	2,500	3,000	3,500
Less: Projected cash flows of NRPL Ltd. without merger	(1,000)	(1,500)	(2,000)	(2,500)	(3,000)
	500	500	500	5,00	500

(2) Valuation of FIL in case of merger

Year	*Cash Flows from operations (₹ in crores)*	*Discount Factor*	*Discounted Cash Flow (₹ in crores)*
1	500	0.870	435.00
2	500	0.756	378.00
3	500	0.658	329.00
4	500	0.572	286.00
5	500	0.497	248.50
			1,676.50

(3) Maximum value to be quoted

	₹ *in crores*	₹ *in crores*
Value as per discounted cash flows from operations		1,676.50
Add: Increase in goodwill of NRPL on acquisition of FIL		300
		1,976.50
Add: Cash to be collected immediately by disposal of assets:		
Fixed Assets	100	
Investments	1,500	
Inventory	30	1,630.00
		3,606.50
Less: Current liabilities (1,000 – 102) (See Note below)	898	
Compensations claim	510	(1,408.00)
		2,198.50

So, NRPL can quote as high as ₹ 2,198.50 crores for taking over the business of FIL.

(4) Valuation of FIL ignoring merger (as a 'Stand Alone' entity)

Year	*Cash Flows*	*Discount Factor*	*Discounted Cash Flow*
	(₹ in crores)		*(₹ in crores)*
1	400	0.870	348.00
2	400	0.756	302.40
3	600	0.658	394.80
4	800	0.572	457.60
5	1,000	0.497	497.00
			1,999.80

Note: As per adjustment (d) given in point (iv), Provision of ₹ 102 crores (i.e. 20% on ₹ 510 crores) was made for contingent liabilities. It implies that this provision is included in the current liabilities covered under point (iii). Therefore, payment of current liabilities has been paid after deduction of the provision amount of ₹ 102 crores and full payment of contingent liability of ₹ 510 crores has been made to avoid double payment of same item.

Question 26

The summarized Balance Sheet of Rose Limited for the year ended on 31st March, 2015, 2016 and 2017 are as follows:

	(₹ in thousands)		
	31st March, 2015	*31st March 2016*	*31st March 2017*
Liabilities			
6,40,000, Equity shares of ₹ 10 each fully paid up	6,400	6,400	6,400
General Reserves	4,800	5,600	6,400
Profit and Loss Account	560	640	960
Trade Payable	2,400	3,200	4,000
Total	14,160	15,840	17,760
Assets			
Goodwill	4,000	3,200	2,400
Tangible Assets (Net)	5,600	6,400	6,400
Inventories	4,000	4,800	5,600
Trade Receivable	80	640	1,760
Cash and Cash Equivalents	480	800	1,600
Total	14,160	15,840	17,760

Additional Information:

(i) Actual valuations were as under:

Tangible Assets	7,200	8,000	8,800
Inventories	4,800	5600	6,400
Net Profit (Including Opening Balance after writing off depreciation, goodwill, tax provision and transfers to general reserves)	1,680	2,480	3,280

(ii) Capital employed in the business at market value at the beginning of 2014-2015 was ₹ 1,46,40,000 which included cost of goodwill. The normal annual return on average capital employed in the line of business in which Rose Limited is engaged is 12.50%.

(iii) The balance in general reserve as on 1st April, 2014 was ₹ 40 lacs.

(iv) The goodwill shown as on 31st March, 2015 was purchased on 1st April, 2014 for ₹ 40 lacs and the balance in profit and loss account as on 1st April, 2014 was ₹ 4,80,000.

(v) Goodwill is to be valued at 5 years' purchase of super profit by using simple average method.

Find out the average capital employed in each year and total value of business as on 31st March, 2017.

Answer

Total value of business as on 31.03.2017

	₹ in thousands
Closing Capital Employed as on 31.3.2017	16,960
Less: Goodwill appearing in the Balance Sheet as purchased goodwill	(2,400)
Add: Goodwill	8,225
Total Value of Business	22,785

Working Notes:

1. Calculation of Average Capital Employed

	31.3.2015 *₹ in thousands*	*31.3.2016* *₹ in thousands*	*31.3.2017* *₹ in thousands*
Purchased Goodwill*	4,000	3,200	2,400
Tangible Assets	7,200	8,000	8,800
Inventories	4,800	5,600	6,400
Trade Receivables	80	640	1,760
Cash & Cash Equivalents	480	800	1,600
	16,560	18,240	20,960
Less: Trade payables	(2,400)	(3,200)	(4,000)
Closing Capital Employed	14,160	15,040	16,960
Add: Opening Capital Employed	14,640	14,160	15,040
Total	28,800	29,200	32,000
Average Capital Employed (ACE)	14,400	14,600	16,000

*Since the goodwill has been purchased, it is taken as a part of capital employed. However, writing off of the goodwill is an extra-ordinary item, therefore not considered while calculating Future Maintainable Profit.

2. Valuation of Goodwill

(i) Future Maintainable Profit

	31.3.2015 *₹ in thousands*	31.3.2016 *₹ in thousands*	31.3.2017 *₹ in thousands*
Future Maintainable Profit	1,680	2,480	3,280
Less : Opening Profit	(480)	(560)	(640)

	Add: Appreciation of closing inventory	800	800	800
	Less: Appreciation of opening inventory	-	(800)	(800)
	Add: Transferred to General Reserve	800	800	800
	Goodwill written off		800	800
		2,800	3,520	4,240
	Less: Normal Return @ 12.5% on ACE	(1,800)	(1,825)	(2,000)
(ii)	Super Profit	1,000	1,695	2,240

(iii) Average Super Profit = $\left[\frac{1,000 + 1,695 + 2,240}{3}\right] = 1,645$ thousands

(iv) Value of Goodwill at five years' purchase

= ₹ 1,645 thousands × 5 = ₹ 8,225 thousands.

Exercise

Question 1

The summarised Balance Sheets of X Ltd. are as follows:

		(₹ in lakhs)
Liabilities	*As at 31.3.2016*	*As at 31.3.2017*
Share Capital	*1,000.0*	*1,000.0*
General Reserve	*800.0*	*850.0*
Profit and Loss Account	*120.0*	*175.0*
Term Loans	*370.0*	*330.0*
Trade Payables	*70.0*	*90.0*
Provision for Tax	*22.5*	*25.0*
Proposed Dividend	*200.0*	*250.0*
	2,582.5	*2,720.0*
Assets		
Fixed Assets and Investments (Non-trade)	*1,600.0*	*1,800.0*
Inventory	*550.0*	*600.0*
Trade Receivables	*340.0*	*220.0*
Cash and Bank	*92.5*	*100.0*
	2,582.5	*2,720.0*

Other Information:

1. *Current cost of fixed assets excluding non-trade investments on 31.3.2016 ₹ 2,200 lakhs and on 31.3.2017 ₹ 2,532.8 lakhs.*
2. *Current cost of inventory on 31.3.2016 ₹ 670 lakhs and on 31.3.2017 ₹ 750 lakhs.*
3. *Non-trade investments in 10% government securities ₹ 490 lakhs.*
4. *Trade Receivables include foreign exchange Trade Receivables amounting to $ 70,000 recorded at the rate of $ 1 = ₹ 17.50 but the closing exchange rate was $ 1 = ₹ 21.50.*
5. *Trade Payables include foreign exchange Trade Payables amounting to $ 1,20,000 recorded at the rate of $ 1 = ₹ 16.50 but the closing exchange rate was $ 1 = ₹ 21.50.*
6. *Profit included ₹ 120 lakhs being government subsidy which is not likely to recur.*
7. *₹ 247 lakhs being the last instalment of R and D cost were written off the profit and loss account. This expenditure is not likely to recur.*
8. *Tax rate during 2016-2017 was 50% effective future tax rate is estimated at 40%.*
9. *Normal rate of return is expected at 15%.*

Based on the information furnished, Mr. Iral, a director contends that the company does not have any goodwill. Examine his contention.

[Answer: Capital employed as at 31.3.14 and 31.3.15 will be ₹ 2840 and ₹ 3,154.6 lakhs respectively; average capital employed ₹ 2,997.3 lakhs; Future maintainable profit ₹ 488.88 lakhs; Goodwill ₹ 39.28 lakhs]

Question 2

Capital structure of Lot Ltd. as at 31.3.2017 as under:

	(₹ in lakhs)
Equity share capital	*10*
10% preference share capital	*5*
15% debentures	*8*
Reserves	*4*

Lot Ltd. earns profits of ₹ 5 lakhs annually on an average before deduction of interest on debentures and income tax which works out to 40%.

Normal return on equity shares of companies similarly placed is 12% provided:

(a) *Profit after tax covers fixed interest and fixed dividends at least 3 times.*

(b) *Capital gearing ratio is .75.*

(c) *Yield on share is calculated at 50% of profits distributed and at 5% on undistributed profits.*

Lot Ltd. has been regularly paying equity dividend of 10%.

Compute the value per equity share of the company considering the paid up value of ₹ 100 per share.

[**Answer: Profit for calculation of interest and fixed dividend coverage ₹ 3,48,000; Calculation of interest and fixed dividend coverage: $\frac{3,48,000}{1,70,000} = 2.05$ times ; Capital gearing ratio: $\frac{13,00,000}{14,00,000} = 0.93$ (approximately) ; Yield on equity shares: $\frac{53,900}{10,00,000} \times 100 = 5.39\%$; Expected yield of equity shares: 13.00; Value per equity share: = $\frac{5.39}{13.00}$ × ₹ 100 = ₹ 41.46]**

Question 3

Write short notes on:

(i) Difficulties in brand accounting

(ii) Market value model of business valuation

(iii) Cost approach of valuation

Question 4

From the following particulars of three companies, ascertain the value of goodwill. Terms and conditions are as follows:

(i) Assets are to be revalued.

(ii) Goodwill is to be valued at four years' purchase of average super profits for three years. Such average is to be calculated after adjustment of depreciation at ten per cent on the amount of increase/decrease on revaluation of fixed assets. Income tax is to be ignored.

(iii) Normal profit on capital employed is to be taken at 10 per cent, capital employed being considered on the basis of net revalued amounts of tangible assets.

The summarized Balance Sheets and relevant information are given below:

							(₹ in lakhs)
Liabilities	P Ltd.	Q Ltd.	R Ltd.	Assets	P Ltd.	Q Ltd.	R Ltd.
Equity shares of ₹ 10 each	12.00	14.00	6.00				-
Reserves	2.00		2.00	Net tangible block	16.00	12.00	10.00
10% Debentures	4.00	-	2.00	Current assets	6.00	5.00	2.00
Trade Payables	4.00	3.00	2.00				
	22.00	17.00	12.00		22.00	17.00	12.00

	P Ltd. ₹	*Q Ltd.* ₹	*R Ltd.* ₹
Revaluation of tangible block	*20,00,000*	*10,00,000*	*12,00,000*
Revaluation of current assets	*7,00,000*	*2,80,000*	*1,60,000*
Average annual profit for three years before charging debenture interest	*3,60,000*	*2,88,000*	*1,56,000*

[Answer: Goodwill of P Ltd. ₹ 7,60,000, Q Ltd. and R Ltd. Nil. Capital employed of P Ltd. ₹19,00,000, Q Ltd. ₹9,80,000 and R Ltd. ₹9,60,000]

10

Developments in Financial Reporting

BASIC CONCEPTS

VALUE ADDED STATEMENT

Value Added (VA) is the wealth; a reporting entity has been able to create through the collective effort of capital, management and employees. In economic terms, value added is the market price of the output of an enterprise less the price of the goods and services acquired by transfer from other firms. VA can provide a useful measure in gauging performance and activity of the reporting entity.

The conventional VA statement is divided into two parts – the first part shows how VA is arrived at and the second part shows the application of such VA.

Gross Value Added (GVA): GVA is arrived at by deducting from sales revenue the cost of all materials and services which were brought in from outside suppliers. Besides sales revenue, any direct income, investment income and extraordinary incomes or expenses are also included in calculation of GVA. Including these items the equation, we get

(Sales revenue + Direct incomes) – Bought in cost of materials and services + Investment incomes + Extraordinary items = Retained profit + Depreciation + Wages + Interest + Tax + Dividend

Net Value Added (NVA): NVA can be defined as GVA less depreciation.

The various advantages of the VA statement are:

(a) Reporting on VA improves the attitude of employees towards their employing companies.

(b) VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA.

(c) VA based ratios (e.g. VA/Payroll, Taxation/VA, VA/Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful. However, it may be noted that the VA ratios can be made more useful if the ratios are based on inflation adjusted VA data.

(d) VA provides a very good measure of the size and importance of a company.

(e) VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.

It is generally found that value addition is highest for service companies and lowest for a trading business.

ECONOMIC VALUE ADDED

EVA as a residual income measure of financial performance is simply the operating profit after tax less a charge for the capital, equity as well as debt, used in the business.

EVA helps to :

- Measure the financial performance.
- Take important managerial decisions.
- Equate managerial incentives with shareholder's interest.
- Improve financial & business literacy throughout the firm.

Cost of Capital

The term 'Cost of Capital' means the cost of long term funds of a company. It is the multiple of 'Capital Employed' and Weighted Average Rate of Cost of Debt Capital, Cost of Equity Capital and Cost of Preference Share Capital. This is why cost of capital is known as Weighted Average Cost of Capital (WACC). WACC is post tax. Capital Employed represents the total of Debt Capital, Equity Capital and Preference Share Capital.

Cost of Debt Capital

Cost of Debt Capital is the discount rate that equates the present value of after tax interest payment cash outflows to the current market value of the Debt Capital. Due to the tax-benefit on interest payment on debt capital, Cost of Debt is, generally, lower than the cost of Equity Capital,

Cost of Equity Capital

Cost of Equity Capital is the market expected rate of return. Equity capital and accumulated reserves and surpluses which are free to equity shareholders carry the same cost. Cost of Preference Capital is the discount rate that equates the present value of after tax interest payment cash outflows to the current market value of the Preference Share Capital.

Factors involved in calculating EVA:

$$\text{Cost of Debt } (K_d) = \frac{\text{Interest on Long Term Borrowings (1-Tax rate)}}{\text{Long Term Borrowings}} \times 100$$

$$\text{Cost of Preference Capital } (K_p) = \frac{\text{Preference Divind}}{\text{Preference Share Capital}}$$

Cost of Equity (K_e) = Risk free rate (R_f) + Beta [Market rate (R_m)– Risk free rate (R_f)]

Cost of Retained Earnings (K_r)

Beta

Ungeared Beta = Industry Beta / [1 + (1–Tax Rate) (Industry Debt Equity Ratio)]

Geared Beta = Ungeared Beta/[1 + (1 – tax rate) (Debt Equity Ratio)]

Equity Risk Premium = Market rate(R_m) – Risk free rate (R_f)]

Market Rate of Return (R_m) =

$$\frac{\text{Stock exchange index (at the end of the year} - \text{at the beginning of the year}}{\text{Stock exchange index at the beginning of the year}}$$

Overall cost of capital = $K_d \text{ X } \frac{\text{Debt}}{\text{Total funds}} + K_p \text{ X } \frac{\text{PSC}}{\text{Total funds}} + K_e \text{X} \frac{\text{Equity}}{\text{Total funds}}$

Total Funds = Debt + Preference Capital + Equity Funds.

Capital Asset Pricing Model

Capital Asset Pricing Model (CAPM) is the most widely used method of calculating the Cost of Equity Capital. Under CAPM cost of Equity Capital is expressed as

Risk Free Rate + Specific Risk Premium = Risk Free Rate + Beta X Equity Risk Premium

= Risk Free Rate + Beta X (Market Rate - Risk Free Rate)

Specific Risk Premium is a multiple of Beta and Equity Risk Premium.

Beta: Beta is a relative measure of volatility that is determined by comparing the return on a share to the return on the stock market. In simple terms, the greater the volatility, the riskier the share and the higher the Beta. For the companies, which are not listed in stock exchanges, beta of the similar industry may be considered after transforming it to un-geared beta and then re-gearing it according to the debt equity ratio of the company. The formula for un-gearing and gearing beta is shown below.

Ungeared Beta = Industry Beta / [1 + (1–Tax Rate) (Industry Debt Equity Ratio)]

Geared Beta = Ungeared Beta/[1+ (1 – tax rate) (Debt Equity Ratio)]

Equity Risk Premium: Equity Risk Premium is the excess return above the risk free rate that investors demand for holding risky securities. It is calculated as “Market rate of Return (MRR) minus Risk Free Rate”. Market rate may be calculated from the movement of share market indices over a period of an economic cycle basing on moving average to smooth out abnormalities. Many of them do not calculate the MRR but on an ad-hoc basis they assume 8% to 12% as the equity risk premium.

MARKET VALUE ADDED

Market Value Added (MVA) is the difference between the current market value of a firm and the capital contributed by investors. If MVA is positive, the firm has added value. If it is negative the firm has destroyed value.

To find out whether management has created or destroyed value since its inception, the firm's MVA can be used:

MVA = Market Value of Capital - Capital employed

SHAREHOLDERS VALUE ADDED

Shareholders' Value Added is a value-based performance measure of a company's worth to shareholders. The basic calculation is net operating profit after tax (NOPAT) minus the cost of capital from the issuance of debt and equity, based on the company's weighted average cost of capital (WACC).

HUMAN RESOURCE REPORTING

Human resource reporting is an attempt to identify, quantify and report investments made in human resources of an organisation that are not presently accounted for under conventional accounting practice. However, "human resources" are not yet recognised as 'assets' in the balance sheet.

Value Added Statement

Question 1

What are the advantages of preparation of Value Added (VA) statements? Explain in brief.

Answer

Various advantages of preparation of Value Added (VA) Statements are as under:

1. Improves the attitude of employees -Reporting on VA improves the attitude of employees towards their employing companies. This is because the VA statement reflects a broader view of the company's objectives and responsibilities.
2. Productivity linked bonus -VA statement makes it easier for the company to introduce a productivity linked bonus scheme for employees based on VA. The employees may be given productivity bonus on the basis of VA / Payroll Ratio.
3. Ratio Analysis-VA based ratios (e.g. VA / Payroll, taxation / VA, VA / Sales etc.) are useful diagnostic and predictive tools. Trends in VA ratios, comparisons with other companies and international comparisons may be useful.
4. Reflect Corporate Significance-VA provides a very good measure of the size and importance of a company. To use sales figure or capital employed figures as a basis for company's rankings can cause distortion. This is because sales may be inflated by large bought-in expenses or a capital-intensive company with a few employees may appear to be more important than a highly skilled labour–intensive company.
5. Contribution to Economy-VA statement links a company's financial accounts to national income. A company's VA indicates the company's contribution to national income.
6. Strong Conceptual-VA statement is built on the basic conceptual foundations which are currently accepted in balance sheets and income statements. Concepts such as going

concern, matching, consistency and substance over form are equally applicable to VA statement.

Question 2

From the following Profit and Loss Account of Kalyani Ltd., prepare a Gross Value Added Statement. Show also the reconciliation between Gross Value Added and Profit before Taxation.

Profit and Loss Account for the year ended 31st March, 2017

Income	Notes	Amount (₹ in lakhs)	Amount (₹ in lakhs)
Sales			206.42
Other Income			10.20
			216.62
Expenditure			
Production and Operational Expenses	1	166.57	
Administration Expenses	2	6.12	
Interest and Other Charges	3	8.00	
Depreciation		5.69	186.38
Profit before Taxes			30.24
Provision for taxes			(3.00)
			27.24
Investment Allowance Reserve Written Back			0.46
Balance as per Last Balance Sheet			1.35
			29.05
Transferred to:			
General Reserve		24.30	
Proposed Dividend		3.00	27.30
Surplus Carried to Balance Sheet			1.75
			29.05

Notes:

			(₹ in lakhs)
(1)	Production and Operational Expenses		
	Decrease in Stock		30.50
	Consumption of Raw Materials		80.57
	Consumption of Stores		5.30
	Salaries, Wages, Bonus and Other Benefits		12.80
	Cess and Local Taxes		3.20

	Other Manufacturing Expenses		*34.20*
			166.57
(2)	*Administration expenses include inter-alia Audit fees of ₹ 1 lakh, Salaries and commission to directors ₹ 2.20 lakhs and Provision for doubtful debts ₹ 2.50 lakhs.*		
			(₹ in lakhs)
(3)	*Interest and Other Charges:*		
	On Fixed Loans from Financial Institutions		*3.90*
	Debentures		*1.80*
	On Working Capital Loans from Bank		*2.30*
			8.00

Answer

Kalyani Ltd.
Value Added Statement
for the year ended 31st March, 2017

	₹ in lakhs	*₹ in lakhs*	%
Sales		206.42	
Less: Cost of bought in material and services:			
Production and operational expenses	150.57		
Administration expenses	3.92		
Interest on working capital loans	2.30	(156.79)	
Value Added by manufacturing and trading activities		49.63	
Add: Other income		10.20	
Total Value Added		59.83	
Application of Value Added:			
To Pay Employees:			
Salaries, Wages, Bonus and other benefits		12.80	21.39
To Pay Directors:			
Salaries and Commission		2.20	3.68
To Pay Government:			
Cess and Local Taxes	3.20		
Income Tax	3.00	6.20	10.36
To Pay Providers of Capital:			
Interest on Debentures	1.80		
Interest on Fixed Loans	3.90		
Dividend	3.00	8.70	14.54

To Provide for maintenance and Expansion of the company:			
Depreciation	5.69		
General Reserve (₹ 24.30 – ₹ 0.46)	23.84		
Retained profit (₹ 1.75 – ₹ 1.35)	0.40	29.93	50.03
		59.83	100.00

Reconciliation Between Total Value Added and Profit Before Taxation:

	(₹ in lakhs)	*(₹ in lakhs)*
Profit before tax		30.24
Add back:		
Depreciation	5.69	
Salaries, Wages, Bonus and other benefits	12.80	
Directors' Remuneration	2.20	
Cess and Local Taxes	3.20	
Interest on Debentures	1.80	
Interest on Fixed Loans	3.90	29.59
Total Value Added		59.83

Question 3

From the following Profit & Loss Account of Brightex Co. Ltd., prepare a gross value added statement for the year ended 31.12.2016:

Show also the reconciliation between gross value added and profit before taxation.

Profit and Loss Account for the year ended 31.12.2016

	Notes	*(₹ '000)*	*(₹ '000)*
Income:			
Sales			*6,240*
Other Income			*55*
			6,295
Expenditure:			
Production and operational expenses	*1*	*4,320*	
Administration expenses (Factory)	*2*	*180*	
Interest & Other charges	*3*	*624*	
Depreciation		*16*	*(5,140)*
Profit before tax			*1,155*
Provision for tax			*(55)*

			1,100
Balance as per last Balance Sheet			*60*
			1,160
Transferred to fixed assets replacement reserve		*400*	
Dividend paid		*160*	*(560)*
Surplus carried to Balance Sheet			*600*

Notes:

1. *Production & Operation expenses:*

Consumption of raw materials	*3,210*
Consumption of stores	*40*
Local tax	*8*
Salaries to administrative staff	*620*
Other manufacturing expenses	*442*
	4,320

2. *Administration expenses include salaries and commission to directors* *5*
3. *Interest on other charges include:*
   (a) *Interest on bank overdraft (Overdraft is of temporary nature)* *109*
   (b) *Fixed loan from I.C.I.C.I.* *51*
   (c) *Working capital loan from I.F.C.I.* *20*
   (d) *Excise duties amount to one-tenth of total value added by manufacturing and trading activities.*

Answer

Brightex Co. Ltd
Value Added Statement
For the year ended 31st December, 2016

	(₹ in thousands)	*(₹ in thousands)*	*% thousands*
Sales			6,240
Less: Cost of bought in material and services:			
Production and operational expenses			
₹ (4,320 – 8 – 620)		3,692	

Administration expenses ₹ (180 – 5)		175	
Interest on bank overdraft		109	
Interest on working capital loan		20	
Excise duties (Refer to working note)		180	
Other/miscellaneous charges ₹ (444–180)		264	(4,440)
Value added by manufacturing and trading activities			1,800
Add: Other income			55
Total Value Added			1,855
Application of Value Added:			
To Pay Employees :			
Salaries to Administrative staff		620	33.42
To Pay Directors:			
Salaries and Commission		5	0.27
To Pay Government:			
Local Tax	8		
Income Tax	55	63	3.40
To Pay Providers of Capital :			
Interest on Fixed Loan	51		
Dividend	160	211	11.37
To Provide for Maintenance and Expansion of the Company:			
Depreciation	16		
Fixed Assets Replacement Reserve	400		
Retained Profit ₹ (600 - 60)	540	956	51.54
		1,855	100.00

Reconciliation between Total Value Added and Profit before Taxation:

	(₹ in thousands)	(₹ in thousands)
Profit before Tax		1,155
Add back:		
Depreciation	16	
Salaries to Administrative Staff	620	

Director's Remuneration	5	
Interest on Fixed Loan	51	
Local Tax	8	700
Total Value Added		1,855

Working Note:

Calculation of Excise Duty

		(₹ in thousands)
Interest and other charges		624
Less : Interest on bank overdraft	109	
Interest on loan from ICICI	51	
Interest on loan from IFCI	20	(180)
Excise duties and other/miscellaneous charges		444

Assuming that these miscellaneous charges have to be taken for arriving at Value Added

(In the first part of Value Added Statement), the excise duty will be computed as follows:

Let excise duty be x; thus miscellaneous/ other charges = ₹ 444 -x

Thus x = 1/10 x [₹ 6,240 - {₹ 3692+ ₹ 175+ ₹ 109+ ₹ 20+ x + (₹444-x)}]

= 1/10 x [₹ 6240 - ₹ 4440] = ₹ 180

Other/ miscellaneous charges = ₹ 444 - ₹ 180 = ₹ 264

The above solution is given accordingly.

However, if other/miscellaneous charges are taken as any type of application of Value Added (i.e, to be taken in the application part), then excise duty (x) will be computed as follows:

x = 1/10 x [₹ 6240 - ₹ (3692 + 175 + 109 + 20 + x)]

x = 1/10 x [₹ 2244 -x]

11x = ₹ 2244

x = ₹ 204

And thus total value added will be ₹ 2040 + ₹ 55 (other income) = ₹ 2095

And accordingly, application part will be prepared, taking miscellaneous charges.

₹ ('000) 240 [i.e, ₹ 444 - ₹ 204] as the application of value added.

Question 4

On the basis of the following income statement pertaining to Brite Ltd., you are required to prepare:

(a) Gross value added statement; and

(b) Statement showing reconciliation of gross value added with Profit Before Taxation.

Profit and Loss Account of Brite Ltd.
for the year ended 31st March, 2017

	(₹ in thousands)	(₹ in thousands)
Income		
Sales less returns		15,27,956
Dividends and interest		130
Miscellaneous income		474
(A)		15,28,560
Expenditure		
Production and operational expenses:		
Decreases in inventory of finished goods	26,054	
Consumption of raw materials	7,40,821	
Power and lighting	1,20,030	
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Excise duty	14,540	
Other manufacturing expenses	32,565	13,42,010
Administrative expenses:		
Directors' remuneration	7,810	
Other administrative expenses	32,640	40,450
Interest on:		
9% Mortgage debentures	14,400	
Long-term loan from financial institution	10,000	
Bank overdraft	100	24,500
Depreciation on fixed assets		50,600
(B)		14,57,560
Profit before Taxation (A) — (B)		71,000
Provision for Income-tax		25,470
Profit after Taxation		45,530

Balance of account as per last Balance Sheet		*6,300*
		51,830
Transferred to:		
General reserve 40% of ₹ 45,530	*18,212*	
Dividend @ 22%	*22,000*	
Tax on distributed profits @ 16.995%	*3,739*	*(43,951)*
Surplus carried to Balance Sheet		*7,879*

Answer

Brite Ltd.
Value Added Statement for the year ended 31st March, 2017

	(₹ in thousands)	*(₹ in thousands)*
Sales less returns		15,27,956
Less: Cost of bought in materials and services, as per working note	9,34,010	
Administrative expenses	32,640	
Interest on bank overdraft	100	(9,66,750)
Value added by manufacturing and trading activities		5,61,206
Add: Dividends and interest		130
Miscellaneous income		474
Total value added		5,61,810

Application of valued added

	(₹ in thousands)	*(₹ in thousands)*	%
To pay Employees:			
Wages, salaries and bonus	3,81,760		
Staff welfare expenses	26,240	4,08,000	72.62
To pay Directors:			
Directors' remuneration		7,810	1.39
To pay Government:			
Income tax	25,470		
Tax on distributed profits	3,739	29,209	5.20
To pay providers of capital:			

Interest on 9% debentures	14,400		
Interest on long-term loan from financial institution	10,000		
Dividend to shareholders	22,000	46,400	8.26
To provide for maintenance and expansion of the company:			
Depreciation on Fixed assets	50,600		
Transfer to General reserve	18,212		
Retained profit ₹ (7,879-6,300) (in 000's)	1,579	70,391	12.53
		5,61,810	100.00

Statement showing reconciliation of Total value added with Profit before taxation

	(₹ in thousands)	*(₹ in thousands)*
Profit Before Taxation		71,000
Add back:		
Wages, salaries and bonus	3,81,760	
Staff welfare expenses	26,240	
Directors' remuneration	7,810	
Interest on 9% mortgage debentures	14,400	
Interest on long-term loan from financial institution	10,000	
Depreciation on fixed assets	50,600	4,90,810
Total Value Added		5,61,810

Working Note:

Calculation of cost of bought in materials and services:

	(₹ in thousands)
Decrease in inventory of finished goods	26,054
Consumption of raw materials	7,40,821
Excise duty	14,540
Power and lighting	1,20,030
Other manufacturing expenses	32,565
	9,34,010

Question 5

On the basis of the following Profit and Loss Account of Zed Limited and the supplementary information provided thereafter, prepare Gross Value Added Statement of the company for the year ended 31st March, 2017. Also prepare another statement showing reconciliation of Gross Value Added with Profit before Taxation.

Profit and Loss Account of Zed Limited for the year ended 31st March, 2017.

	Amount (₹ in lakhs)	Amount (₹ in lakhs)
Income		
Sales		5,010
Other Income		130
		5,140
Expenditure		
Production and Operational Expenses	3,550	
Administrative Expenses	185	
Interest	235	
Depreciation	370	(4,340)
Profit before Taxation		800
Provision for Taxation		(280)
Profit after Taxation		520
Credit Balance as per last Balance Sheet		40
		560
Appropriations		
Transfer to General Reserve		100
Preference Dividend (Interim) paid		50
Proposed Preference Dividend (Final)		50
Proposed Equity Dividend		300
Balance carried to Balance Sheet		60
		560
Supplementary Information		
Production and Operational Expenses consist of:		
Raw Materials and Stores consumed		1,900
Wages, Salaries and Bonus		610

Local Taxes including Cess		*220*
Other Manufacturing Expenses		*820*
		3,550
Administrative Expenses consist of:		
Salaries and Commission to Directors		*60*
Audit Fee		*24*
Provision for Bad and Doubtful Debts		*20*
Other Administrative Expenses		*81*
		185
Interest is on:		
Loan from Bank for Working Capital		*35*
Debentures		*200*
		235

Answer

Gross Value Added Statement of Zed Ltd.
for the year ended 31st March, 2017

		(₹ in lakhs)	*(₹ in lakhs)*
Sales			5,010
Less:	Cost of raw materials, stores and other services consumed	2,720	
	Administrative expenses	125	
	Interest on loan from bank for working capital	35	(2,880)
Value added by manufacturing and trading activities			2,130
Add:	Other income		130
Total value added			2,260

Application of Value Added

	(₹ in lakhs	*(₹ in lakhs)*	*%*
To pay employees			
Wages, salaries and bonus		610	26.99
To pay directors			
Salaries and commission to Directors		60	2.66
To pay Government			

	Local taxes including cess	220		
	Income tax	280	500	22.12
To	pay providers of capital			
	Interest on debentures	200		
	Preference dividend	100		
	Equity dividend	300	600	26.55
To	provide for the maintenance and expansion of the company:			
	Depreciation	370		
	Transfer to general reserve	100		
	Retained profit ₹ (60 – 40) lakhs	20	490	21.68
			2,260	100.00

Statement showing Reconciliation between Gross Value Added with Profit before Taxation

	(₹ in lakhs)	*(₹ in lakhs)*
Profit before taxation		800
Add back:		
Wages, salaries and bonus	610	
Salaries and commission to Directors	60	
Local taxes including cess	220	
Interest on debentures	200	
Depreciation	370	1,460
Gross Value Added		2,260

Question 6

Value Added Ltd. furnishes the following Profit and Loss A/c:

Profit and Loss A/c for the year ended 31st March, 2017

Income	*Notes*	*(₹ '000)*
Turnover	*1*	*29,872*
Other Income		*1,042*
		30,914
Expenditure		
Operating expenses	*2*	*26,741*

Interest on 8% Debenture		*987*
Interest on Cash Credit	*3*	*151*
Excise duty		*1,952*
		29,831
Profit before depreciation		*1,083*
Less: Depreciation		*(342)*
Profit before tax		*741*
Provision for tax	*4*	*(376)*
Profit after tax		*365*
Less: Transfer to Fixed Assets Replacement Reserve		*(65)*
		300
Less: Dividend paid		*(125)*
Retained Profit		*175*

Notes:

(1) Turnover is based on invoice value and net of sales tax.

(2) Salaries, wages and other employee benefits amounting to ₹ 14,761 ('000) are included in operating expenses.

(3) Cash Credit represents a temporary source of finance. It has not been considered as a part of capital.

(4) Transfer of ₹ 54 ('000) to the credit of deferred tax account is included in provision for tax.

Prepare value added statement for the year ended 31st March, 2017 and reconcile total value added with profit before taxation.

Answer

Value Added Ltd.

Value Added Statement for the year ended 31st March, 2017

	(₹ '000)	*(₹ '000)*	%
Turnover		29,872	
Less: Cost of bought in materials and services:			
Operating expenses (₹ 26,741 –₹ 14,761)	11,980		
Excise duty	1,952		
Interest on Cash Credit	151	(14,083)	
Value added by manufacturing and trading activities		15,789	

Add: Other income		1,042	
Total value added		16,831	
Application of value added:			
To Pay to employees:			
Salaries, wages and other employee benefits		14,761	87.70
To Pay to Government:			
Corporation tax (₹ 376 – ₹ 54)		322	1.91
To Pay to providers of capital:			
Interest on 8% Debentures	987		
Dividends	125	1,112	6.61
To Provide for maintenance and expansion of the company:			
Depreciation	342		
Fixed Assets Replacement Reserve	65		
Deferred Tax Account	54		
Retained Profit	175	636	3.78
		16,831	100

Note: Deferred tax account could alternatively be shown as an item 'To pay to government'.

Reconciliation between total value added and profit before taxation

	(₹ '000)	*(₹ '000)*
Profit before tax		741
Add back: Depreciation	342	
Wages, salaries and other benefits	14,761	
Debenture interest	987	16,090
Total Value Added		16,831

Question 7

From the following Profit and Loss account of New Mode Reporting Ltd., prepare a gross value added statement for the year ended 31st December, 2016. Show also the reconciliation between GVA and Profit before taxation:

Profit and Loss Account

	(₹ '000)	*(₹ '000)*
Income		
Sales	*12,480*	

Other income	110	12,590
Expenditure		
Production and Operational expenditure	8,640	
Administrative expenses	360	
Interest and other charges	1,248	
Depreciation	32	(10,280)
Profit before tax		2,310
Less: Provision for tax		(110)
Profit after tax		2,200
Add: balance as per last Balance Sheet		120
		2,320
Less: Transfer to Fixed assets replacement Reserve	800	
Dividend paid	320	(1,120)
Surplus carried to Balance Sheet		1,200

Additional information:

		₹
(i)	Production and Operational expenses consists of	
	Consumption of Raw materials	64,20,000
	Consumption of Stores	80,000
	Local tax	16,000
	Salaries to Administrative staff	12,40,000
	Other Manufacturing expenses	8,84,000
(ii)	Administrative expenses include salaries and commission to directors	10,000
(iii)	Interest and other charges include-	
	(a) Interest on bank overdraft (overdraft is of temporary nature)	2,18,000
	(b) Interest on Fixed loan from SIDBI	1,02,000
	(c) Interest on Working capital loan from IFCI	40,000
	(d) Excise duties	?
(iv)	Excise duties amount to one-tenth of total value added by manufacturing and trading activities.	

Answer

New Mode Reporting Ltd.
Value Added Statement for the year ended 31st December, 2016

		(in ₹ '000)
Sales		12,480
Less: Cost of Materials and Services:		
Production and Operational Expenses ₹ (8,640–16-1,240)	7,384	
Administrative Expenses ₹ (360 – 10)	350	
Interest on Bank Overdraft	218	
Interest on Working Capital Loan	40	
Excise Duties (Refer to working note)	360	
Other/miscellaneous charges ₹ (888 – 360)	528	8,880
Value added by manufacturing and trading activities		3,600
Add: Other Income		110
Gross value added from operations		3,710

Application of Gross Value Added

	(₹ in '000)	(₹ in '000)	%
To Pay Employees:			
Salaries to Administrative Staff		1240	33.42
To Pay Directors:			
Salaries and Commission		10	0.27
To Pay Government:			
Local Taxes	16		
Income Tax	110	126	3.40
To Pay Providers of Capital:			
Interest on Fixed Loan	102		
Dividend	320	422	11.37
To Provide for maintenance and expansion of the company:			
Depreciation	32		
Fixed Assets Replacement Reserve	800		
Retained Profit (₹ 1200 – 120)	1080	1912	51.54
		3,710	100.00

Reconciliation between Gross Value added and Profit Before Taxation

		(₹ '000)
Profit before Tax		2,310
Add Back: Depreciation	32	
Salaries to Administrative Staff	1,240	
Directors' Salaries and Commission	10	
Interest on Fixed Loan	102	
Local Tax	16	1,400
Total value added		3,710

Working Note:

Calculation of excise duty	*(₹ '000)*	*(₹ '000)*
Interest and other charges		1,248
Less: Interest on bank overdraft	218	
Interest on SIDBI loan	102	
Interest on IFCI loan	40	(360)
Excise duty and other charges		888

Assuming that these other /miscellaneous charges will be deducted for arriving at the value added, the excise duty will be calculated as follows:

Let Excise Duties be denoted by - E

Then, other charges = ₹ 888 - E

Excise duty are $\frac{1}{10th}$ of value added

Hence E = $\frac{1}{10th}$ [₹ 12,480 – {₹ 7,384+ ₹ 350+ ₹ 218 + ₹ 40+ E + (₹ 888 – E)}]

= $\frac{1}{10th}$ [₹ 12,480 – ₹ 8,880] = $\frac{1}{10th}$ × ₹ 3,600= ₹ 360

Other/miscellaneous charge ₹ 888 – ₹ 360 = ₹ 528

The above solution has been given accordingly.

Alternatively, if other/miscellaneous charges are considered as application of value added (i.e., not deducted for deriving the value added), calculation of Excise Duties (E) will be as follows:

E = $\frac{1}{10th}$ [₹ 12,480 – (₹ 7,384 + ₹ 350 + ₹ 218+ ₹ 40+E)]

E = $\frac{1}{10th}$ × (₹ 4,488 - E)

11E = ₹ 4,488

E = ₹ 408

And thus other/miscellaneous charges will be ₹ 888 – ₹ 408 = ₹ 480

Gross Value added in this case will be ₹ 4,080 + ₹ 110 (Other income) = ₹ 4,190

And accordingly, application part will be prepared after taking other/miscellaneous charges.

Question 8

Prepare a value added statement for the year ended on 31.3.2017 and reconciliation of total value added with profit before taxation, from the Profit and Loss Account of Futures Ltd. for the year ended on 31.3.2017:

		(₹ in '000)
Income:		
Sales	24,400	
Other Income	508	24,908
Expenditure:		
Operating cost	21,250	
Excise duty	1,110	
Interest on Bank Overdraft	75	
Interest on 9% Debenture	1,200	23,635

	(₹ in '000)
Profit before Depreciation	1,273
Depreciation	(405)
Profit before tax	868
Provision for tax	(320)
Profit after tax	548
Proposed Dividend	(48)
Retained Profit	500

The following additional Information are given:

(i) Sales represents Net sales after adjusting Discounts, Returns and Sales tax.

(ii) Operating cost includes ₹ 82,50,000 as wages, salaries and other benefits to Employees.

(iii) Bank overdraft is temporary.

Answer

Value Added Statement of M/s Futures Ltd.

		(₹ in'000)	
Sales		24,400	
Less: Operating cost - Cost of bought in material & services (₹ 21,250 – ₹ 8,250)	13,000		
Excise duty	1,110		
Interest on bank overdraft	75	(14,185)	
Value added by trading and manufacturing activities		10,215	
Add: Other income		508	
Total value added		10,723	
Application of value added			%
To Pay Employees:			
Wages, salaries and other benefits		8,250	76.94
To Pay Government : Corporate tax		320	2.98
To Pay providers of capital:			
Interest on 9% debentures	1,200		
Dividends	48	1,248	11.64
To Provide for maintenance and expansion of the company:			
Depreciation	405		
Retained profit	500	905	8.44
		10,723	100.00
Reconciliation			
Profit before tax		868	
Depreciation		405	
Wages, salaries and other benefits		8,250	
Debenture interest		1,200	
		10,723	

Question 9

Prepare a value added statement for the year ended on 31.03.2017 and reconciliation of total value added with profit before taxation, from the profit and loss account of Paradise Ltd. for the year ended on 31-03-2017.

Income:	*(₹ in lakhs)*
Sales	*254.00*
Other income	*6.00*
Total	*260.00*
Expenditure:	
Operating cost	*222.00*
Excise duty	*11.20*
Interest on bank overdraft	*1.00*
Interest on 9% debentures	*15.00*
	249.20
Profit before depreciation	*10.80*
Depreciation	*4.10*
Profit before tax	*6.70*
Provision for tax	*2.40*
Profit after tax	*4.30*
Proposed dividend	*0.30*
Retained profit	*4.00*

The following additional information are given:

(i) Sales represents net sales after adjusting discounts, returns and sales tax.

(ii) Operating cost includes ₹ 82.00 lakhs as wages, salaries and other benefits to employees.

(iii) Bank overdraft is temporary.

Answer

Value Added Statement of M/s. Paradise Ltd.

		₹ in lakhs
Sales		254.00
Less: Cost of bought in material and services:		
Operating cost (₹ 222.00 lakhs – ₹ 82 lakhs)	140.00	
Excise duty	11.20	
Interest on bank overdraft	1.00	(152.20)
Value added by trading activities		101.80
Add: Other income		6.00
Total Value Added		107.80

Application of value added

		₹ *in lakhs*	%
To pay Employees:			
Wages, salaries and other benefits		82.00	76.07
To pay Government : Corporate tax		2.40	2.23
To pay Providers of Capital :			
Interest on 9% debentures	15.00		
Dividends	0.30	15.30	14.19
To provide for Maintenance and Expansion of the Company			
Depreciation	4.10		
Retained profit	4.00	8.10	7.51
		107.80	100

Reconciliation between Total Value Added and Profit before Taxation:

	₹ *in lakhs*
Profit before tax	6.70
Add back:	
Depreciation	4.10
Wages, salaries and other benefits	82.00
Interest on debentures	15.00
Total Value Added	107.80

Question 10

Famous Corporation has been preparing Value Added Statements for the past five years. The Human Resource Manager of the company has suggested introducing a value added incentive scheme to motivate the employees for their better performance. To introduce the scheme, it is proposed that the best index performance (favourable to employer) i.e. Employee Costs to Added Value for the last five years, will be used as the target index for future calculations of the bonus to be paid.

After the target index is determined, any actual improvement in the index will be rewarded. The employer and the employee will be sharing any such improvement in the ratio of 1:2. The bonus is given at the end of the year, after the profit for the year is determined.

The following information is available for the last 5 years.

Value Added Statement for 5 years

Particulars					₹ *in thousands*
	2012	*2013*	*2014*	*2015*	*2016*
Sales	*5,600*	*7,600*	*9,200*	*10,400*	*12,000*

Less: Bought in goods & services	2,560	4,000	5,000	5,600	6,400
Added Value	3,040	3,600	4,200	4,800	5,600
Employee Costs	1,300	1,520	1,680	1,968	2,240
Dividend	200	300	400	480	600
Taxes	640	760	840	1000	1,120
Depreciation	520	620	720	880	1,120
Debenture Interest	80	80	80	80	80
Retaining Earnings	300	320	480	392	440
Added Value	3,040	3,600	4,200	4,800	5,600

Summarised Profit and Loss Account for the year ended on 31st March, 2017

Particulars		(₹ in thousand)
		Amount
Income		
Sales less returns	13,600	
Dividends and Interest	500	
Miscellaneous Income	500	14,600
Expenditure		
Production and Operational Expenses:		
Cost of Materials	5,000	
Wages & Salaries	1,800	
Other Manufacturing Expenses	1,400	8,200
Administrative Expenses:		
Administrative Salaries	600	
Administration Expenses	600	1,200
Selling and Distribution Expenses:		
Selling and Distribution Salaries	120	
Selling Expenses	400	520
Financial Expenses:		
Debenture Interest		80
Depreciation		1,520
Total Expenditure		11,520
Profit before taxation		3,080

Provision for taxation		*770*
Profit after taxation		*2,310*

From the above information, prepare Value Added Statement for the year 2016-2017 and determine the amount of bonus payable to employees, if any.

Answer

1. Calculation of Target index

					(₹ in thousands)
Year	*2012*	*2013*	*2014*	*2015*	*2016*
Employees cost	1,300	1,520	1,680	1,968	2,240
Value added	3,040	3,600	4,200	4,800	5,600
Percentage of 'Employee cost' to 'Value added'	42.76%	42.22%	40%	41%	40%

Target index percentage is taken as least of the above from the employer's viewpoint i.e. 40%.

2. Value Added Statement for the year 2016-2017

	(₹ in thousands)	*(₹ in thousands)*
Sales		13,600
Less: Cost of bought in goods & services		
Materials consumed	5,000	
Other manufacturing expenses	1,400	
Administrative expenses	600	
Selling expenses	400	(7,400)
		6,200
Add: Miscellaneous income		500
Dividends and interest		500
Value Added		7,200

3. Employee cost for 2016-2017

	(₹ in thousands)
Wages and salaries	1,800
Administrative salaries	600
Selling and distribution salaries	120
	2,520

4. **Calculation of target employee cost** = Target Index Percentage x Value added

= 40% x ₹ 7,200 thousands = ₹ 2,880 thousands

5. **Calculation of savings**

Target employee cost	=	₹ 2,880 thousands
Less: Actual Cost	=	(₹ 2,520 thousands)
Saving	=	₹ 360 thousands

6. **Calculation of Bonus payable for the year 2016-2017:**

2/3 of savings is Bonus Payable = ₹ 360 thousands x 2/3 = ₹ 240 thousands.

Economic Value Added and Market Value Added

Question 11

Explain the concept of 'Economic value added' (EVA for short) and its uses.

Answer

Economic Value Added (EVA) for short, is primarily a benchmark to measure earnings efficiency. Though the term "Economic Profit" was very much there since the inception of "Economics", Stern Stewart & Co., of USA has got a registered Trade Mark for this by the name "EVA", an acronym for Economic Value Added. Its uses can be explained as:

(a) Measurement of financial performance - EVA as a residual income measure of financial performance, is simply the operating profit after tax less a charge for the capital, equity as well as debt, used in the business. EVA includes profit and loss as well as balance sheet efficiency as well as the ROCE, or ROE.

(b) Impact on shareholders' wealth - In addition, EVA is a management tool to focus managers on the impact of their decisions in increasing shareholders' wealth. These include both strategic decisions such as what investments to make, which businesses to exit, what financing structure is optimal; as well as operational decisions involving trade-offs between profit and asset efficiency such as whether to make in house or outsource, repair or replace a piece of equipment, whether to make short or long production runs etc.

Most importantly the real key to increasing shareholder wealth is to integrate the EVA framework in four key areas; to measure business performance; to guide managerial decision making; to align managerial incentives with shareholders' interests; and to improve the financial and business literacy throughout the organisation.

To better align managers interests with Shareholders – the EVA framework needs to be holistically applied in an integrated approach – simply measuring EVAs is not enough it must also become the basis of key management decisions as well as be linked to senior management's variable compensation.

Question 12

Write short note on Market Value Added.

Answer

Market value added is the market value of capital employed in the firm less the book value of capital employed. Market value added is calculated by summing up the paid up value of equity and preference share capital, Retained earnings, long term and short term debts and subtracting this sum from the market value of equity and debt.

Market value added measures cumulatively the performance of corporate entity.

A High market value added means that the company has created substantial wealth for share holders. On the other hand, negative MVA means that the value of management's actions and investments are less than the value of the capital contributed to the company by the capital market or that the wealth and value has been destroyed.

Question 13

The following information is available of a concern; calculate E.V.A.:

Debt capital 12%	*₹ 2,000 crores*
Equity capital	*₹ 500 crores*
Reserve and surplus	*₹ 7,500 crores*
Capital employed	*₹ 10,000 crores*
Risk-free rate	*9%*
Beta factor	*1.05*
Market rate of return	*19%*
Equity (market) risk premium	*10%*
Net Operating profit after tax	*₹ 2,100 crores*
Tax rate	*30%*

Answer

E.V.A. = NOPAT – COCE

NOPAT = Net Operating Profit after Tax

COCE = Cost of Capital Employed

COCE = Weighted Average Cost of Capital × Average Capital Employed

= WACC × Capital Employed

Debt Capital		₹ 2,000 crores
Equity capital (500 + 7,500)	=	₹ 8,000 crores

Capital employed	=	₹ 2,000+ ₹ 8,000 = ₹ 10,000 crores
Debt to capital employed	=	$\frac{2,000}{10,000}=0.20$
Equity to Capital employed	=	$\frac{8,000}{10,000}=0.80$
Debt cost before Tax		12%
Less: Tax (30% of 12%)		3.6%
Debt cost after Tax		8.4%

According to Capital Asset Pricing Model (CAPM)

Cost of Equity Capital = Risk Free Rate + Beta × Equity Risk Premium

Or

= Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 9 + 1.05 × (19-9)

= 9 + 1.05 × 10 = 19.5%

WACC = Equity to CE x Cost of Equity capital + Debt to CE x Cost of debt

= 0.8× 19.5% + 0.20× 8.40%

= 15.60% + 1.68% = 17.28%

COCE = WACC × Capital employed

= 17.28% × ₹ 10,000 crores = ₹ 1728 crores

E.V.A. = NOPAT – COCE

= ₹ 2,100 – ₹ 1,728 = ₹ 372 crores

Question 14

Pilot Ltd. supplies the following information using which you are required to calculate the economic value added.

Financial Leverage	*1.4 times*	
Capital (equity and debt)	*Equity shares of ₹ 1,000 each*	*34,000 (number)*
	Accumulated profit	*₹ 260 lakhs*
	10 percent Debentures of ₹ 10 each	*80 lakhs (number)*
Dividend expectations of equity shareholders	*17.50%*	
Prevailing Corporate Tax rate	*30%*	

Answer

Computation of EVA	*(₹ in lakhs)*
Net profit after tax (Refer Working Note 1)	140
Add: Interest adjusted for tax effect (800 × 10% × 0.70)	56
Return to Providers of Funds	196
Less: Cost of Capital (Refer Working Note 2)	(161)
Economic Value Added (EVA)	35

Working Notes:

1. Interest and Net Profit

$$\text{Financial Leverage} = \frac{\text{Profit before Interest \& Taxes (PBIT)}}{\text{Profit before Tax (PBT)}}$$

Interest on Borrowings = ₹ 800,00,000 × 10% = ₹ 80 lakhs

Therefore, $1.40 = \frac{\text{PBIT}}{\text{PBIT} - \text{Interest}}$

$1.40 = \frac{\text{PBIT}}{\text{PBIT} - 80}$

1.40 (PBIT- 80)	=	PBIT
1.40 PBIT- 112	=	PBIT
1.40 PBIT- PBIT	=	112
0.40 PBIT	=	112
PBIT	=	112/0.40
PBIT	=	₹ 280 Lakhs
PBT = PBIT – I=280-80	=	₹ 200 lakhs
Less: Tax (30%)	=	(₹ 60) lakhs
Net profit after tax	=	₹ 140 lakhs

2. Cost of Capital

	(₹ in lakhs)
Equity Shareholders' funds	600
10% Debenture holders' funds	800
Total	1,400

Weights assigned to Equity shareholders fund = $\frac{600}{1400}=0.4286$ Weights assigned to Debenture holders = $\frac{800}{1400}=0.5714$	

Source of Funds (1)	*Amount ₹ (in lakhs)* (2)	*Weight* (3)	*Cost %* (4)	*WACC %* (5)=(3 × 4)%
Equity share holders' funds	600	0.4286	17.50	7.50
Debenture holders' funds	800	0.5714	7.00*	4.00
Total	1400	1.0000	----	11.50

Cost of Capital = Average Capital Employed × Weighted Average cost of Capital (WACC)

= ₹ 1,400 lakhs × 11.50% = ₹ 161 lakhs.

Question 15

From the following information of Vinod Ltd., compute the economic value added:

(i)	*Share capital*	*₹ 2,000 lakhs*
(ii)	*Reserve and surplus*	*₹ 4,000 lakhs*
(iii)	*Long-term debt*	*₹ 400 lakhs*
(iv)	*Tax rate*	*30%*
(v)	*Risk free rate*	*9%*
(vi)	*Market rate of return*	*16%*
(vii)	*Interest*	*₹ 40 lakhs*
(viii)	*Beta factor*	*1.05*
(ix)	*Profit before interest and tax*	*₹ 2,000 lakhs*

Answer

Vinod Limited

Computation of Economic Value Added

Economic Value Added	(₹ *in Lakhs*
Net Operating Profit after Tax (Refer Working Note 5)	1,372.00
Add: Interest on Long-term Fund (Refer Working Note 2)	28.00
	1,400.00

*Rate of interest net of corporate tax of 30%.

Less: Cost of Capital ₹ 6,400 lakhs × 15.77% (Refer working notes 3 and 4)	(1,009.28)
Economic Value Added	390.72

Working Notes:

1. **Cost of Equity** = Risk free Rate + Beta Factor (Market Rate – Risk Free Rate)

   9% + 1.05 (16 – 9) = 9% + 7.35% = 16.35%

2. **Cost of Debt**

Interest	₹ 40 lakhs
Less: Tax (30%)	(₹ 12 lakhs)
Interest after Tax	₹ 28 lakhs

   Cost of Debt = $\frac{28}{400} \times 100 = 7\%$

3. **Weighted Average Cost of Capital**

Cost of Equity	₹ 6,000 lakhs × 16.35%	(W.N.1)	₹ 981 lakhs
Cost of Debt	₹ 400 lakhs × 7%	(W.N.2)	₹ 28 lakhs
			₹ 1,009 lakhs

   WACC = $\frac{1{,}009}{6{,}400} \times 100 = 15.77\%$ (approx.)

4. **Capital Employed**

	(₹ *in lakhs)*
Share Capital	2,000
Reserves and Surplus	4,000
Long term debts	400
	6,400

5. **Net Operating Profit after Tax**

	(₹ in lakhs)
Profit before Interest and Tax	2,000
Less: Interest	(40)
	1,960
Less: Tax 30% on 1,960 Lakhs	(588)
Net Operating Profit after Tax	1,372

Question 16

Prosperous Bank has a criterion that it will give loans to companies that have an "Economic Value Added" greater than zero for the past three years on an average. The bank is considering lending money to a small company that has the economic value characteristics shown below. The data relating to the company is as follows:

(i) Average operating income after tax equals ₹ 25,00,000 per year for the last three years.

(ii) Average total assets over the last three years equals ₹ 75,00,000.

(iii) Weighted average cost of capital appropriate for the company is 10% which is applicable for all three years.

(iv) The company's average current liabilities over the last three years are ₹ 15,00,000.

Does the company meet the bank's criterion for a positive economic value added?

Answer

Calculation of Economic Value Added

	₹
Net Operating Profit After Tax	25,00,000
Less: Cost of capital employed (Refer W.N.)	(6,00,000)
Economic Value Added	19,00,000

Economic value added is greater than zero. Therefore, the company qualifies for the loan.

Working Note:

Calculation of Cost of Capital employed	₹
Average total assets	75,00,000
Less: Average current liabilities	(15,00,000)
Capital employed	60,00,000

Cost of capital = Capital employed x Weighted average cost of capital

$$= ₹\ 60,00,000 \times \frac{10}{100} = ₹\ 6,00,000$$

Question 17

Life Industries Ltd (LIL) furnishes the following information from which you are required to calculate the prevailing Economic Value Added of the company and also explain the reason for the difference, if any, between the EVA as calculated by you and the MVA (Market Value Added) of LIL amounting to ₹ 14005 crores.

Common shares of ₹ 1,000 face value	*1,58,200 units*
12% Debentures ₹ 10 face value	*50,00,000 units*
Current tax rate	*30%*
Financial Leverage	*1.1 times*
Securities Premium Account (Rupees in lakhs)	*155*
Free Reserves (Rupees in lakhs)	*154*
Capital Reserve (Rupees in lakhs)	*109*

It is a prevailing practice for companies in the industry to which LIL belongs to pay at least a dividend of 15% p.a. to its common shareholders.

Answer

Computation of Economic Value Added

	₹ in lakhs
Profit after tax	420
Add: Interest net of tax = 60 x $\left(\frac{100-30}{100}\right)$	42
Return to providers of funds	462
Less: Cost of Capital	(342)
Economic Value Added	120

MVA of ₹ 14005 crore:

The MVA of ₹ 14005 crore is the difference between the current Market Value of LIL and the capital contributed by the fund providers. While EVA measures current earning efficiency of the company, MVA takes into consideration the EVA from not only the assets in place but also from the future projects/activities of the company. The difference between MVA over EVA thus represents the value attributed to the future potential of the company & may change from time to time based on market sentiments. In short the MVA is the net present value of all future EVA's.

Working Notes:

1. **Calculation of Net Profit after interest and tax**

Interest on Debentures = 50,00,000 units x 10 x 12% = ₹ 60,00,000

Therefore, Financial Leverage = $\frac{\text{Profit before Interest \& taxes (PBIT)}}{\text{PBIT less Interest}}$

$$1.10 = \frac{\text{PBIT}}{\text{PBIT} - ₹\ 60,00,000}$$

1.10 (PBIT – ₹ 60,00,000) = PBIT

1.10 PBIT – ₹ 66,00,000 = PBIT

1.10 PBIT – PBIT = ₹ 66,00,000

0.10 PBIT = ₹ 66,00,000

PBIT = ₹ 6,60,00,000

Profit after interest but before tax = ₹ 6,60,00,000 – ₹ 60,00,000 = ₹ 6,00,00,000

Less: Income Tax @ 30%	(₹ 1,80,00,000)
Profit After Interest & Tax	₹ 4,20,00,000

2. Calculation of Weighted Average Cost of Capital (WACC)

	₹ in lakhs	*Amount (₹) (1)*	*Weight (2)*	*Cost% (3)*	*WACC% (4)=2x3*
Equity Shareholders' fund					
Common Shares	1,582				
Securities Premium	155				
Free Reserves	154				
Capital Reserves	109				
		2,000	0.80	15	12.00
Debentureholders' fund		500	0.20	8.4*	1.68
		2,500	1.00		13.68

Cost of Capital = Capital Employed x WACC%

= ₹ 2,500 lakhs x 13.68%

= ₹ 342 lakhs

Question 18

The following information (as of 31-03-2017) is supplied to you by M/s Fox Ltd.:

			(₹ in crores)
(i)	*Profit after tax (PAT)*		*205.90*
(ii)	*Interest*		*4.85*
(iii)	*Equity Share Capital*	*40.00*	
	Accumulated surplus	*700.00*	
	Shareholders fund	*740.00*	

* Rate of interest on debentures is taken net of tax of 30%.

	Loans (Long term)	*<u>37.00</u>*	
	Total long term funds		*777.00*
(iv)	*Market capitalization*		*2,892.00*
Additional information:			
(a)	*Risk free rate*		*12.00 percent*
(b)	*Long Term Market Rate (Based on BSE Sensex)*		*15.50 percent*
(c)	*Effective tax rate for the company*		*25.00 percent*
(d)	*Beta (β) for last few years*		
	Year		
	1	*0.48*	
	2	*0.52*	
	3	*0.60*	
	4	*1.10*	
	5	*0.99*	

Using the above data you are requested to calculate the Economic Value Added of Fox Ltd. as on 31st March, 2017.

Answer

Net Operating Profit After Tax (NOPAT) = Profit After Tax (PAT) + Interest (net of tax)

= 205.90 + 4.85 x (1-0.25) = ₹ 209.54 crores

Debt Capital		₹ 37 crores
Equity capital (40 + 700)	=	₹ 740 crores
Capital employed	=	₹ 37 +₹ 740 = ₹ 777 crores
Debt to capital employed	=	₹ 37 crores/₹ 777 crores = 0.0476
Equity to capital employed	=	₹ 740 crores /₹ 777 crores =0.952
Interest cost before Tax		₹ 4.85 crores
Less: Tax (25% of ₹ 4.85 crores)		<u>(₹ 1.21 crores)</u>
Interest cost after tax		**₹ 3.64 crores**
Cost of debt	=	(₹ 3.64 crores/ ₹ 37 crores) x 100
	=	9.83%

According to Capital Asset Pricing Model (CAPM)

Beta for calculation of EVA should be the highest of the given beta for the last few years. Accordingly,

Cost of Equity Capital = Risk Free Rate + Beta (Market Rate – Risk Free Rate)

= 12% + 1.10 × (15.50% - 12%)

= 12% + 1.10 × 3.5% = 15.85%

Weighted Average Cost of Capital (WACC)

= Equity to Capital Employed (CE) x Cost of Equity Capital + Debt to CE x Cost of Debt

= 0.952× 15.85% + 0.0476 × 9.83%

= 15.09% + 0.47% = 15.56%

Cost of Capital Employed (COCE) = WACC × Capital Employed

= 15.56% × ₹ 777 crores = ₹ 120.90 crores

Economic Value Added (E.V.A.) = NOPAT – COCE

= ₹ 209.54 crores – ₹ 120.90 crores = ₹ 88.64 crores

Question 19

DISA & Co. has provided the following information:

	(₹ in lacs)
Equity Share Capital (₹ 10 each)	*400*
15% Preference Share Capital (₹ 10 each)	*200*
Reserves and Surplus	*220*
15% Debentures	*1600*
10% Non-trade Investments (Nominal Value ₹ 100 lacs)	*140*
Land and Building held as Investment	*20*
Advance given for Purchase of Plant	*10*
Capital Work in Progress	*30*
Underwriting Commission (not written off)	*20*
Earnings per share	*16*
Tax rate	*30%*
Beta factor	*1.65*
Market rate of return	*16.25%*
Risk free rate	*9.85%*

Calculate Economic Value Added by the company.

Answer

Computation of Economic Value Added (EVA)

Particulars	*(₹ in lacs)*
Net Operating Profit after Tax (NOPAT)	831.00
Less: Weighted average cost of operating capital employed (13.35% of 2,200) (See W.N.7)	(293.70)
Economic Value Added (EVA)	537.30

Working Notes:

1. **Net Operating Profit after Tax (NOPAT)**

Earnings per share	₹ 16
No. of Equity Shares	40 lacs
	₹ in lacs
Profit after Interest, Tax & Preference Dividend [40 lacs x ₹ 16]	640.00
Add: Preference Dividend (15% of ₹ 200 lacs)	30.00
Profit after Tax	670.00
Add: Tax @ 30% [670/70 x 30]	287.14
Profit before Tax	957.14
Add: Interest on Debentures [15% of ₹ 1,600 lacs]	240.00
Profit before Interest & Tax	1,197.14
Less: Income from Non-Trade Investment [10% of ₹ 100 lacs]	(10.00)
Net Operating Profit before Tax	1,187.14
Less: Tax @ 30%	(356.14)
Net Operating Profit after Tax [NOPAT]	831.00

2. **Cost of Equity** = Risk Free Rate + Beta Factor x (Market Rate - Risk Free Rate)

   = 9.85% + 1.65 (16.25-9.85) = 20.41%

3. **Cost of Preference shares** = 15%

4. **Cost of Debt** = Interest Rate x (1 - tax rate) = 15% x (1 - 0.30) = 10.5%

5. **Total Capital Employed** = [Equity Share Capital + Retained Earnings + Preference Share Capital + Debentures]

   = [400 + (220 - 20) + 200 + 1,600] = 2,400

6. Weighted Average Cost of Capital (WACC)

$$= \left(\frac{600}{2,400} \times 20.41\%\right) + \left(\frac{200}{2,400} \times 15\%\right) + \left(\frac{1,600}{2,400} \times 10.5\%\right)$$

= 5.10 + 1.25 + 7% = 13.35%

7. Operating Capital Employed

		₹ *in lacs*
Total Capital		2,400
Less: Non-operating Capital Employed		
10% Non-Trade Investment	140	
Land and Building held as Investment	20	
Advance given for purchase of a Plant	10	
Capital work-in-progress	30	(200)
Operating Capital Employed		2,200

Human Resource Reporting

Question 20

Write short notes on:

(a) Jaggi and Lau model on valuation on group basis of Human Resources.

(b) Opportunity cost (HRA).

(c) Human Resource Accounting.

Answer

(a) According to Jaggi and Lau Model, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organisation or not. An individual's expected service tenure in the organisation is difficult to predict but on a group basis it is relatively easy to estimate the percentage of people in a group likely to leave the organisation in future. This model attempted to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:

(i) Ascertain the number of employees in each rank.

(ii) Estimate the probability that an employee will be in his rank within the organisation or terminated/promoted in the next period. This probability will be estimated for a specified time period.

(iii) Ascertain the economic value of an employee in a specified rank during each time period.

(iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau simplified the process of measuring the value of human resources by considering a group of employees as valuation base. But in the process, they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

(b) **Opportunity Cost:** It is one of the Economic value models used for measurement and valuation of Human assets. As per this model, opportunity cost is the value of an employee in his alternative use. This opportunity cost is used as a basis for estimating the value of Human resources. Opportunity cost value may be established by competitive bidding within the firm so that in effect, Managers must bid for any scarce employee. A Human asset will have a value only if it is a scarce resource, that is, when its employment in one division denies it to another division. This method excludes employees of the type of which can be readily hired from outside the firm. Also, it is in very rare cases that managers would like to bid for an employee.

(c) Human Resource Accounting (HRA) is an attempt to identify, quantify and report investments made in human resources of an organization. Leading public sector units like OIL, BHEL, NTPC and SAIL etc. have started reporting human resources in their annual reports as additional information. Although human beings are considered as the prime mover for achieving productivity, and are placed above technology, equipment and money, the conventional accounting practice does not assign significance to the human resource. Human resources are not thus recognized as 'assets' in the Balance Sheet. While investments in human resources are not considered as assets and not amortised over the economic service life, the result is that the income and expenditure statement comprising current revenue and expenditure gives a distorted picture of the real affairs of the organization.

Accountants have been severely criticized by the Behavioural Scientists for their failure to value human resources, as this has come out as a handicap for effective management.

Human resource accounting provides scope for planning and decision making in relation to proper manpower planning. Also, such accounting can bring out the effect of various new rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes and laws.

Question 21

Briefly describe the method of valuation of human resources as suggested by Jaggi and Lau. Also point out the special merit and demerit of this method.

Answer

Jaggi and Lau suggested a model for valuation of human resources. According to them, proper valuation of human resources is not possible unless the contributions of individuals as a group are taken into consideration. A group refers to homogeneous employees whether working in the same department or division of the organization or not. An individual's expected service tenure in an organization is difficult to predict, but on a group basis, it is relatively easy to estimate the percentage of people in a group likely to leave the organization in future. This model attempts to calculate the present value of all existing employees in each rank. Such present value is measured with the help of the following steps:

(i) Ascertain the number of employees in each rank.

(ii) Estimate the probability that an employee will be in his rank within the organization on terminated/promoted in the next period. This probability will be estimated for a specified time-period.

(iii) Ascertain the economic value of an employee in a specified rank during each time period.

(iv) The present value of existing employees in each rank is obtained by multiplying the above three factors and applying an appropriate discount rate.

Jaggi and Lau tried to simplify the process of measuring the value of human resources by considering a group of employees as basis of valuation. But in the process they ignored the exceptional qualities of certain skilled employees. The performance of a group may be seriously affected in the event of exit of a single individual.

Merit

Jaggi and Lau model approached the valuation of human resources on the basis of grouping of employees. Under this method, calculations get simplified and the chances of errors get reduced.

Demerit

This model ignores individual skills of the employees. The varied skills of the employees is are not recognized in the valuation process under Jaggi and Lau model.

Question 22

Briefly describe the progress made by India so far in the field of human resource accounting.

Answer

Human resource accounting can be defined as the process of identifying, measuring and communicating information about human resources in financial statements in order to facilitate effective management. Human resource accounting is a recent phenomenon in India. Leading public sector units like OIL, BHEL, NTPC, MMTC and SAIL etc. have started reporting Human Resources in their annual reports as additional information. The Indian Companies basically adopted the model of human resource valuation as advocated by Lev and Schwartz (1971).

Indian Companies focused their attention on the present value of employee earning as a measure of their human capital. However, the Indian Companies have suitably modified the Lev and Schwartz model to suit their individual circumstances.

Question 23

Give an account of the growing scope of human capital reporting.

Answer

Of late there is a growing trend of shift from the traditional focus on financial reporting of quantifiable resources (which can be measured in monetary terms) to a more comprehensive approach of reporting under which human resources are also considered as measurable assets. Having followed the methods of accounting of fixed assets, one can take into account the employee-related costs like cost of recruitment, training and orientation of employees, for the purpose of capitalization and then the appropriate portion thereof can be amortized each year over the estimated years of effect of such costs.

The relevance of human resource information lies in the fact that it concerns organizational changes in the firm's human resources. The ratio of human to non-human capital indicates the degree of labour intensity of an organization. Comparison of the specific values of human capital based on the organization's scales of wages and salaries with the general industry standards can be a good source of information to the management. There is no standard human capital reporting format as employment reporting is relatively a new form of reporting. Usually, the report inter alia contains data pertaining to employee numbers, employment and training policies, collective bargaining arrangements, industrial disputes, pension and pay arrangement and disabled employee numbers.

Human capital reporting provides scope for planning and decision-making in relation to proper manpower planning. Also, such reporting can bring out the effect of various rules, procedures and incentives relating to work force, and in turn, can act as an eye opener for modifications of existing statutes, laws and the like.

Question 24

A company has a capital base of ₹ 1 crore and has earned profits to the tune of ₹ 11 lakhs. The Return on Investment (ROI) of the particular industry to which the company belongs is 12.5%. If the services of a particular executive are acquired by the company, it is expected that the profits will increase by ₹ 2.5 lakhs over and above the target profit.

Determine the amount of maximum bid price for that particular executive and the maximum salary that could be offered to him.

Answer

Capital Base	=	₹ 1,00,00,000
Actual Profit	=	₹ 11,00,000
Target Profit @ 12.5%	=	₹ 12,50,000

Expected Profit on employing the particular executive

= ₹ 12,50,000 + ₹ 2,50,000 = ₹ 15,00,000

Additional Profit = Expected Profit – Actual Profit

= ₹ 15,00,000 – ₹ 11,00,000 = ₹ 4,00,000

Maximum bid price = $\frac{\text{Additional Profit}}{\text{Rate of Return on Investment}} = \frac{4,00,000}{12.5} \times 100 = ₹\ 32,00,000$

Maximum salary that can be offered = 12.5% of ₹ 32,00,000 i.e., ₹ 4,00,000

Maximum salary can be offered to that particular executive upto the amount of additional profit i.e., ₹ 4,00,000.

Question 25

From the following details, compute according to Lev and Schwartz (1971) model, the total value of human resources of the employee groups skilled and unskilled.

		Skilled	*Unskilled*
(i)	*Annual average earning of an employee till the retirement age*	*₹ 50,000*	*₹ 30,000*
(ii)	*Age of retirement*	*65 years*	*62 years*
(iii)	*Discount rate*	*15%*	*15%*
(iv)	*No. of employees in the group*	*20*	*25*
(v)	*Average age*	*62 years*	*60 years*

Answer

According to Lev and Schwartz, the value of human capital embodied in a person of age is the present value of his remaining future earnings from employment. Their valuation model for a discrete income stream is given by the following formula:

$$V = \sum_{t=\tau}^{t} \frac{I(t)}{(1+r)^{t-\tau}}$$

Where,

V□ = the human capital value of a person □years old.

I(t) = the person's annual earnings up to retirement.

r = a discount rate specific to the person.

t = retirement age.

Value of skilled employees:

$$= \frac{50,000}{(1+0.15)^{(65-62)}} + \frac{50,000}{(1+0.15)^{(65-63)}} + \frac{50,000}{(1+0.15)^{(65-64)}}$$

₹ 32,875.81 + ₹ 37,807.18 + ₹ 43,478.26 = ₹ 1,14,161.25

Total value of skilled employees is ₹ 1, 14,161.25 × 20 = ₹ 22,83,225.

Value of unskilled employees

$$= \frac{30,000}{(1+0.15)^{(62-60)}} + \frac{30,000}{(1+0.15)^{(62-61)}} = \frac{30,000}{(1+0.15)^{2}} + \frac{30,000}{(1+0.15)}$$

= ₹ 22,684.31 + ₹ 26,086.96 = ₹ 48,771.27

Total value of the unskilled employees = ₹ 48,771.27× 25 = ₹ 12,19,282

Total value of human resources (skilled and unskilled) = ₹ 22,83,225 + ₹ 12,19,282

= ₹ 35,02,507.

Exercise

Question 1

From the following Profit and Loss Account of X Limited, prepare Gross Value Added Statement and show the reconciliation between Gross Value Added and Profit before taxation:

Profit and Loss Account for the year ended 31st March, 2017

Income	*(₹ in lakhs)*	*(₹ in lakhs)*
Sales		*800*
Other Income		*50*
		850
Expenditure		
Production and Operational Expenses	*600*	
Administrative Expenses	*30*	
Interest and Other Charges	*30*	
Depreciation	*20*	*680*
Profit before taxes		*170*
Provision for taxes		*30*
		140
Balance as per last Balance Sheet		*10*
		150
Transferred to:		
General Reserve		*80*
Proposed Dividend		*20*
Surplus carried to Balance Sheet		*50*
		150

Break-up of some of the Expenditure is as follows:		
Production and Operational Expenses:		
Consumption of Raw Materials and Stores		*320*
Salaries, Wages and Bonus		*60*
Cess and Local Taxes		*20*
Other Manufacturing Expenses		*200*
		600
Administrative Expenses:		
Audit Fee		*6*
Salaries and Commission to Directors		*8*
Provision for Doubtful Debts		*6*
Other Expenses		*10*
		30
Interest and other Charges:		
On Working Capital Loans from Bank		*10*
On Fixed Loans from ICICI		*15*
On Debentures		*5*
		30

[Answer: Total Value Added ₹ 298 lakhs; Reconciliation between Gross Value Added and Profit before Taxation- (₹ in lakhs) Profit before tax 170+ Depreciation 20 + Salaries, Wages and Bonus 60+ Directors' Remuneration+ 8 Cess and Local Taxes 20 + Interest on Debentures 5 + Interest on Fixed Loans 15]

Question 2

The following is the Profit and Loss Account of Galaxy Ltd. for the year ended 31.03.2017. Prepare a Gross Value Added Statement of Galaxy Ltd. and show also the reconciliation between Gross Value Added and Profit before taxation.

Profit and Loss Account for the year ended 31.03.2017

	Notes	*(₹ in lakhs)*	
Income:			
Sales		–	*890*
Other Income		–	*55*
			945
Expenditure:			
Production and operational expenses	*(a)*	*641*	–
Administration expenses (Factory)	*(b)*	*33*	–

Interest	*(c)*	*29*	–
Depreciation		*17*	*720*
Profit before taxes		–	*225*
Provision for taxes	*(d)*	–	*30*
Profit after tax		–	*195*
Balance as per last Balance Sheet		–	*10*
			205
Transferred to General Reserve			*45*
Dividend paid			*95*
			140
Surplus carried to Balance Sheet			*65*
			205

Notes:

(a)	*Production and Operational expenses*	*(₹ in lakhs)*
	Consumption of raw materials	*293*
	Consumption of stores	*59*
	Salaries, Wages, Gratuities etc. (Admn.)	*82*
	Cess and Local taxes	*98*
	Other manufacturing expenses	*109*
		641

(b) *Administration expenses include salaries, commission to Directors ₹ 9.00 lakhs Provision for doubtful debts ₹ 6.30 lakhs.*

(c)		*(₹ in lakhs)*
	Interest on loan from ICICI Bank for working capital	*9*
	Interest on loan from ICICI Bank for fixed loan	*10*
	Interest on loan from IFCI for fixed loan	*8*
	Interest on Debentures	*2*
		29

(d) *The charges for taxation include a transfer of ₹ 3.00 lakhs to the credit of Deferred Tax Account.*

(e) *Cess and Local taxes include Excise Duty, which is equal to 10% of cost of bought-in material.*

[Answer: Total value added 396 lakhs; Excise Duty = 549 – 494 = ₹ 55 lakhs]

Question 3

What is economic value added and how is it calculated? Discuss.

Question 4

From the following information of Vinod Ltd., compute the economic value added:

(i)	*Share capital*	*₹ 2,000 lakhs*
(ii)	*Reserve and surplus*	*₹ 4,000 lakhs*
(iii)	*Long-term debt*	*₹ 400 lakhs*
(iv)	*Tax rate*	*30%*
(v)	*Risk free rate*	*9%*
(vi)	*Market rate of return*	*16%*
(vii)	*Interest*	*₹ 40 lakhs*
(viii)	*Beta factor*	*1.05*
(ix)	*Profit before interest and tax*	*₹ 2,000 lakhs*

[Answer: Economic Value Added ₹ 390.72 lakhs; Cost of Equity = 16.35%; Cost of Debt = $\frac{28}{400}\times 100$ **= 7%; Weighted Average Cost of Capital** $\frac{1,009}{6,400}=15.77\%$ **(approx.); Capital Employed ₹ 6,400 lakhs; Net Operating Profit after Tax ₹ 1,372 lakhs]**

Question 5

Why Human Resources Asset is not recognized in the Balance sheet?

Question 6

From the following details, compute the total value of human resources of skilled and unskilled group of employees according to Lev and Schwartz (1971) model:

		Skilled	*Unskilled*
(i)	*Annual average earning of an employee till the retirement age.*	*60,000*	*40,000*
(ii)	*Age of retirement*	*65 years*	*62 years*
(iii)	*Discount rate*	*15%*	*15%*
(iv)	*No. of employees in the group*	*30*	*40*
(v)	*Average age*	*62 years*	*60 years*

[Answer:

Total value of skilled employees= ₹ 1,36,993.50 x 30 employees= ₹ 41,09,805

Total value of unskilled employees = ₹ 65,028.34 x 40 employees = ₹ 26,01,133.60

Total value of human resources (skilled and unskilled) = ₹ 41,09,805 + ₹ 26,01,133.60

= ₹ 67,10,938.60.